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Modernizing Security in Rents: The New Uniform Assignment of Rents Act

*R. Wilson Freyermuth**

INTRODUCTION

Under Article 9 of the Uniform Commercial Code, the creation, perfection, and enforcement of a security interest in the rents of personal property collateral is simple stuff. A security interest in personal property automatically extends to identifiable proceeds of that property, unless the security agreement provides otherwise.¹ Article 9 defines “proceeds” to include whatever is received upon “disposition” of the collateral, and explicitly recognizes that a “lease” of the collateral is a “disposition” – *i.e.*, Article 9 treats “rents” received from the leasing of personal property collateral as “proceeds” of that collateral.² The treatment of personal property rents as “proceeds” reflects the presumed intention of lender and borrower that the lender’s security interest should extend to sums – such as rents – that reflect a return upon the economic value of the collateral.³ As a result, a security interest in personal

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1. U.C.C. §§ 9-315(a)(2), 9-203(f) (2001).

2. *Id.* § 9-102(a)(64)(A).

3. See R. Wilson Freyermuth, *Rethinking Proceeds: The History, Misinterpretation and Revision of U.C.C. Section 9-306*, 69 TUL. L. REV. 645, 659-66, 692-700 (1995); R. Wilson Freyermuth, *Of Hotel Revenues, Rents, and Formalism in the*

property collateral automatically extends to rents arising from that collateral, even if the debtor does not make an express assignment of those rents. Further, Article 9's baseline rules make clear that upon default (or as otherwise agreed by the debtor), the secured party can collect rents due from any lessee of the collateral⁴ and can take possession of any proceeds of the collateral to which it is entitled.⁵

A more cumbersome structure for using rents as security for a mortgage loan has evolved under real property law. This was not always so. Under the traditional "title theory" of mortgage law, the mortgage effected a transfer of legal title to the mortgagee.⁶ As an incident of this title, the mortgagee could collect rents arising from the real property and apply them to the mortgage debt (unless the mortgage document provided to the contrary).⁷ Under this approach, a mortgagee implicitly acquired an interest in the rents arising from the real property, regardless of whether the mortgagee received an express assignment of rents. By contrast, under the now-prevailing "lien theory" of mortgages,⁸ the mortgage does not effect a transfer of legal title to the mortgaged real property. Thus, a mortgage in a lien theory state does not implicitly grant the mortgagee a right to collect rents arising from the mortgaged real property and apply them to the debt.⁹ Yet because rents reflect the economic return received by the owner in exchange for disposing of the right to possess or occupy the real property on a temporary basis – *i.e.*, because rents are "proceeds" of the land in an economic sense – the mortgagee understandably expects to have access to rents arising from the land in the event of the mortgagor's default. For this reason, most commercial mortgage lenders require the mortgagor to deliver a separate "assignment of rents" giving the mortgagee a security interest in rents that accrue from the real property prior to the completion of a foreclosure.

Because real property rents are economically akin to proceeds, the creation, enforceability, and enforcement of a mortgagee's interest in rents ought to parallel the creation, perfection, and enforcement of a secured party's interest in proceeds of personal property collateral. Unfortunately, while Article 9 establishes clear statutory rules for proceeds, there has been no uniform codification of the law governing security in real property rents. To date, only California has enacted a comprehensive statute governing security interests in rents;¹⁰ most states have minimal or no statutory provisions that directly ad-

Bankruptcy Courts: Implications for Reforming Commercial Real Estate Finance, 40 UCLA L. REV. 1461, 1524-35 (1993) [hereinafter, Freyermuth, *Of Hotel Revenues*].

4. U.C.C. § 9-607(a)(1) (2001).

5. *Id.* § 9-607(a)(2).

6. 1 GRANT S. NELSON & DALE A. WHITMAN, REAL ESTATE FINANCE LAW § 4.1, at 153 (4th ed. 2001) [hereinafter NELSON & WHITMAN].

7. *Id.* at 156.

8. See *infra* notes 35-36 and accompanying text.

9. NELSON & WHITMAN, *supra* note 6, § 4.2, at 157.

10. CAL. CIV. CODE § 2938 (1993 & Supp. 2005) (amended 1996).

dress the creation, enforceability, and enforcement of a mortgagee's interest in rents.

Furthermore, while state law governs the creation, enforceability, and enforcement of a mortgagee's interest in rents, disputes regarding rents as security inevitably arise in the bankruptcy context. As a result, federal bankruptcy courts have played the dominant role in elaborating the rules governing whether a mortgagee has properly created a security interest in rents and whether it can enforce that interest against third parties and the mortgagor.¹¹ Over the past two decades, this state of affairs has produced a substantial volume of unnecessary litigation over the creation and enforceability of a mortgagee's interest in rents. Even worse, this litigation has failed to produce consensus rules governing the use of rents as security. Courts in many districts have adopted highly mortgagor-favorable rules that placed unreasonable and inappropriate restrictions upon the mortgagee's ability to collect rents following the mortgagor's default.¹² Courts in other districts have adopted conflicting and highly mortgagee-favorable rules that do not reflect the true nature of the mortgage as a security transaction.¹³ This body of conflicting opinion has needlessly increased the transaction costs associated with the documentation of mortgage loans. Further, it has continued to encourage wasteful litigation over rents from distressed real property – litigation that easily would have been avoided if the law had earlier equated the treatment of real property rents with personal property proceeds.

In the 1990s, California became the only state to enact a comprehensive assignment of rents statute.¹⁴ Based in part upon the success of the California statute, the Joint Editorial Board for Uniform Real Property Acts urged the National Conference of Commissioners on Uniform State Laws (NCCUSL) to promulgate a uniform act governing the creation, enforceability, and enforcement of a security interest in rents. In 2003, following study, NCCUSL appointed a drafting committee, which began meeting in December 2003 to prepare a Uniform Assignment of Rents Act (UARA).¹⁵ At its July 2005 an-

11. As discussed *infra* notes 105-121 and accompanying text, this is because the Bankruptcy Code § 544(a) permits the bankruptcy trustee to avoid any security interest that a judicial lien creditor or a bona fide purchaser of non-fixture real property could have avoided under state law on the petition date.

12. See *infra* notes 105-121, 146-156 and accompanying text.

13. See *infra* notes 125-140 and accompanying text.

14. CAL. CIV. CODE § 2938 (1993 & Supp. 2005) (amended 1996).

15. Consistent with NCCUSL's process, NCCUSL's Scope and Program Committee requested study regarding whether an act would fit NCCUSL's relevance and enactability guidelines for uniform acts. See Study Committee's report, available at http://www.nccusl.org/Update/scope&program/Rpt_MrtgAccess_0603.pdf (last visited Feb. 9, 2006). Interim drafts of UARA during the drafting process are available on the NCCUSL website.

nual meeting in Pittsburgh, Pennsylvania, NCCUSL approved the UARA and recommended its adoption in the various states.¹⁶

This Article explains the provisions of the UARA and encourages its prompt adoption in states that presently lack comprehensive statutes governing security interests in rents. Part I provides a general background about state mortgage law and the nature of the mortgagee's right to rents arising from the mortgaged premises, as well as the general impact of the federal Bankruptcy Code upon a mortgagee's security interest in rents.¹⁷ In Part II, the Article highlights four problem areas that have produced substantial litigation and uncertainty about the enforceability of security interests in rents in the bankruptcy context. These are (a) the proper scope of the term "rents";¹⁸ (b) when a security interest in rents has been properly "perfected";¹⁹ (c) whether a mortgagor can make an "absolute" assignment of rents (as opposed to an assignment for purposes of security);²⁰ and (d) whether a security interest in rents creates an interest that is distinct from the mortgaged real property from which the rents arise.²¹ Part II chronicles the litigation produced by these issues and summarizes the solutions that the UARA provides for each of these issues. In Part III, the Article highlights a variety of other issues relating to the collection of rents, including: (a) the standards governing the appointment of a receiver;²² (b) the mortgagor's liability for "milking" rents (*i.e.*, collecting rents after default without directing them to the payment of the mortgage debt);²³ (c) collection of rents by the mortgagee via direct notification to tenants;²⁴ (d) the extent to which a mortgagee that collects rents must apply those rents to the payment of taxes and other property-related expenses;²⁵ (e) priority among competing assignments of rents;²⁶ (f) priority between an assignee of rents and a person holding an interest in the proceeds of rents arising under UCC Article 9;²⁷ and (g) the effect of the mortgagee's collection of rents upon the mortgagee's ability to enforce the mortgage debt.²⁸ The Article discusses prevailing authority with respect to each issue, particularly highlighting the manner in which the UARA would resolve these

16. *See New Act Facilitates the Financing of Rental Real Estate Properties* (July 28, 2005), available at <http://www.nccusl.org/Update/DesktopModules/NewsDisplay.aspx?ItemID=146> (NCCUSL press release).

17. *See infra* notes 29-43 and accompanying text.

18. *See infra* notes 48-104 and accompanying text.

19. *See infra* notes 105-124 and accompanying text.

20. *See infra* notes 125-145 and accompanying text.

21. *See infra* notes 146-162 and accompanying text.

22. *See infra* notes 171-190 and accompanying text.

23. *See infra* notes 191-200 and accompanying text.

24. *See infra* notes 201-212 and accompanying text.

25. *See infra* notes 213-223 and accompanying text.

26. *See infra* notes 224-232 and accompanying text.

27. *See infra* notes 233-245 and accompanying text.

28. *See infra* notes 246-255 and accompanying text.

issues. The Article concludes with an Appendix that sets forth a bullet-point summary of the primary provisions of the UARA.

I. BACKGROUND

A. State Mortgage Law and the Nature of the Mortgagee's "Right" to Rents

An assignment of leases and rents can serve a number of practical purposes, but its most significant purpose is to provide a mortgage lender with the ability to collect rents that accrue from the mortgaged real property between the mortgagor's default and a completed foreclosure.²⁹ In states that permit only judicial foreclosure,³⁰ the foreclosure process can be quite lengthy – in most states, from six months to a year (and in some cases, in excess of one year).³¹ In this situation, a mortgage lender faces a heightened risk that while foreclosure is pending, the borrower may collect rents and spend them, rather than applying them to reduce the mortgage debt – a process known as “milking” the rents.³² By taking an assignment of leases and rents, the lender manifests its intention to have a lien upon all rents accruing from the land during the term of the mortgage loan (*i.e.*, until the mortgage loan is repaid or until the mortgagee completes a foreclosure after default). The assignment of rents and leases typically permits the mortgagee to take steps following the mortgagor's default to collect rents accruing from the mortgaged premises and apply them to the mortgage debt. These steps may include, *inter alia*, taking physical possession of the premises (becoming a “mortgagee in possession”), obtaining the appointment of a receiver for the premises, or notifying tenants occupying the premises to direct all future rent payments to the mortgagee.

29. Once the foreclosure process is complete, the foreclosure sale purchaser can thereafter collect rents as an incident of its ownership of the land. Thus, an assignment of rents serves primarily to protect the mortgagee's ability to collect rents that accrue while a foreclosure is pending.

30. See FORECLOSURE LAW & RELATED REMEDIES: A STATE-BY-STATE DIGEST (ABA 1995) (foreclosure by judicial process only in Connecticut, Delaware, Florida, Illinois, Indiana, Kansas, Kentucky, Louisiana, New Jersey, North Dakota, Ohio, Pennsylvania, South Carolina, Vermont, and Wisconsin).

31. *Id.* at 184 (six to eighteen months in Kansas), 381 (eight to twenty-two months in New Jersey), 443 (eight to twelve months in Ohio), 557 (six to twelve months in Vermont).

32. This risk is heightened in states that permit the borrower to remain in possession of the real property during a post-sale statutory redemption period. For a general discussion of post-sale statutory redemption and a recognition of the risk that statutory redemption may encourage milking of rents, see NELSON & WHITMAN, *supra* note 6, § 8.4, at 772-75.

To understand the current state of modern law governing a mortgagee's access to rents as security, one must first appreciate the historical development of mortgage law and the mortgagee's right to rents. At early common law, the mortgage operated as an outright conveyance of title to the mortgagee, typically upon a condition subsequent.³³ By virtue of this title transfer, the mortgagee received all incidents of legal title, including the right to possession of the land and the right to collect rents accruing from the land. More importantly, the mortgagee could exercise these incidents even prior to the mortgagor's default (absent contrary agreement).³⁴

Under this "title" theory, the right to collect rents was an incident of the mortgagee's legal estate. As a result, there was no need for a mortgagee to take a separate assignment of rents to secure a mortgage debt. Nevertheless, even in American states that adopted the title theory of mortgages, mortgage lenders commonly require assignments of rents in commercial mortgage transactions. This is not surprising because parties to a mortgage understand it to be only a security device. In the typical case, the parties expect the mortgagor to occupy the premises and to collect rents that accrue prior to default – even if the baseline title theory rule would provide otherwise. Thus, even in title theory states, mortgage documentation commonly provides for an assignment of rents to the mortgagee, but permits the *mortgagor* to collect rents that accrue prior to default.

Over time, the majority of American states have rejected the title theory of mortgages in favor of the "lien" theory.³⁵ Under the lien theory, a mortgage grants the mortgagee only a right of security, capable of being enforced via foreclosure in the event of the mortgagor's default. Until such enforcement occurs, the mortgage does not convey to the mortgagee legal title to the land. Accordingly, the mortgage does not implicitly convey any of the ordinary incidents of title, such as the right to collect rents accruing from the land.³⁶ This means that a lien theory mortgagee would have no way to collect rents (at least those rents that accrued prior to completion of a foreclosure

33. If the mortgagor successfully repaid the loan on a timely basis, this triggered the condition subsequent and permitted the mortgagor to re-enter the premises and terminate the mortgagee's estate. *Id.* § 1.2, at 6.

34. Initially, this structure permitted the mortgagee to collect rents and profits from the land as a substitute for interest, which violated ecclesiastical and legal prohibitions on usury. *Id.* § 1.2, at 7.

35. *Id.* § 4.2, at 156-60 & n.1 (noting that at least 32 states follow the lien theory). Likewise, the Restatement adopts the lien theory. RESTATEMENT (THIRD) OF PROP.: MORTGAGES § 4.1(a) (1997) ("A mortgage creates only a security interest in real estate and confers no right to possession of that real estate on the mortgagee.").

36. A few states (including Maryland, New Jersey, Pennsylvania, and Vermont) adopted an "intermediate" theory, under which the mortgagee's right to possession accrues immediately upon default by the mortgagor, even if the mortgagee has not yet instituted or completed foreclosure proceedings. NELSON & WHITMAN, *supra* note 6, § 4.3, at 160 & n.1.

sale) unless the mortgage documentation specifically assigned those rents as collateral. Thus, in lien theory states, it became customary for a commercial mortgage lender to require the mortgagor to execute an assignment of leases and rents from the mortgaged real property (in addition to the mortgage itself).

Therefore, with respect to the mortgagee's right to rents, whether the jurisdiction follows the title theory or the lien theory is largely irrelevant in the typical mortgage transaction. Instead, the mortgage documents make clear that (a) the mortgagee grants a lien upon the rents accruing from the mortgaged premises, (b) the mortgagor has the right to collect the rents prior to default, and (c) following default, the mortgagee can enforce its lien upon the rents and collect rents that accrue while the mortgagor remains in default.

B. The Potential Impact of Bankruptcy

As a starting point, state law governs the creation and enforcement of security interests in rents.³⁷ Nevertheless, federal bankruptcy courts actually resolve most disputes regarding security interests in rents, because defaulting mortgagors often resort to bankruptcy to take advantage of the automatic stay afforded to bankrupt debtors. Generally speaking, the filing of a bankruptcy petition stays any creditor action to enforce a claim that arose prior to the bankruptcy petition – including an attempt by a mortgagee to foreclose its mortgage – and requires the administration of creditor claims in a collective proceeding supervised by the bankruptcy court.³⁸ When a mortgagor of commercial real property files for bankruptcy, a battle generally develops over the rents that will accrue during the pendency of the bankruptcy case (“post-petition rents”). The mortgagor – often an entity that owns no significant assets other than the mortgaged real property – wants to use post-petition rents to fund its effort to restructure the mortgage debt and to pay professional fees and expenses. In contrast, the mortgagee – who could have taken steps to collect those rents and apply them to the mortgage debt, but for the intervention of the automatic stay – wants to preserve those post-petition rents so that they can be applied to the mortgage debt if necessary.

As a general matter, the Bankruptcy Code preserves any security interest acquired prior to bankruptcy that was both valid and enforceable against third-party creditors under state law.³⁹ Thus, if a mortgage was properly executed, delivered, and recorded prior to bankruptcy,⁴⁰ the mortgage lien continues to remain effective against the mortgaged land following the bank-

37. *Butner v. United States*, 440 U.S. 48, 54 (1979).

38. *See* 11 U.S.C. § 362(a)(4) (2000) (filing of bankruptcy petition operates as stay of “any act to create, perfect, or enforce any lien against property of the estate”).

39. *Id.* § 544(a).

40. Under state law, recording of a mortgage is necessary in order to make the mortgage effective against subsequent bona fide purchasers of the land. *See, e.g.*, MO. REV. STAT. § 442.400 (2000); *see generally* WILLIAM B. STOEBOCK & DALE A. WHITMAN, *THE LAW OF PROPERTY* § 11.9 (3d ed. 2000).

ruptcy petition. Section 552(a) of the Code, however, generally cuts off the enforceability of a pre-petition security agreement to the extent that the agreement would otherwise cover after-acquired property.⁴¹ Section 552(a) serves an important economic function, as an after-acquired property clause (if it remained legally effective) would prevent the debtor from using assets acquired post-petition as collateral to obtain the credit necessary to fund its reorganization.

If section 552(a) applied by its terms to commercial real estate mortgages, a mortgagee with a pre-petition lien upon rents would lose that lien as to post-petition rents. But Congress considered this result inappropriate, because rents are in the nature of a direct economic return upon the land – *i.e.*, in the nature of “proceeds” – and bankruptcy generally respects the lender’s pre-petition lien against the land. Congress thus enacted section 552(b), which allows the mortgagee to retain its lien against post-petition “rents” of the mortgaged premises to the extent provided by underlying state law and the parties’ loan documentation.⁴² Therefore, if the mortgagee has a valid and properly perfected pre-petition lien upon both real estate and its rents, section 552(b) permits the mortgagee to retain a lien against post-petition rents. These post-petition rents constitute the mortgagee’s “cash collateral” – a designation that significantly limits the bankrupt debtor’s flexibility in spending post-petition rents and provides the mortgagee with significant leverage in the bankruptcy proceeding.⁴³

II. “PROBLEM AREAS” OF LITIGATION REGARDING ASSIGNMENTS OF RENTS

The past two decades have produced a great deal of wasteful litigation over a number of issues relating to the proper characterization and treatment of assignments of rents. These issues are: (a) the proper scope of the term “rents”;⁴⁴ (b) when a security interest in rents has been properly “per-

41. 11 U.S.C. § 552(a) (2000) (“Except as provided in [section 552(b)], property acquired by the estate or by the debtor after the commencement of the case is not subject to any lien resulting from any security agreement entered into by the debtor before the commencement of the case.”).

42. *Id.* § 552(b).

43. Section 363(a) of the Bankruptcy Code defines “cash collateral” to include “cash . . . or other cash equivalents whenever acquired in which the estate and an entity other than the estate have an interest” *Id.* § 363(a). This specifically includes the “rent[s] or profits of property and the fees, charges, accounts or other payments for the use or occupancy of rooms and other public facilities in hotels, motels, or other lodging properties subject to a security interest” *Id.* The bankrupt debtor may not use a creditor’s cash collateral unless that creditor consents or unless the court authorizes that use following notice and a hearing, *id.* § 363(c)(2), and then only after providing the creditor with adequate protection of its security interest. *Id.* § 363(e).

44. See *infra* notes 48-104 and accompanying text.

fected";⁴⁵ (c) whether a mortgagor can make an "absolute" assignment of rents (as opposed to an assignment for purposes of security) and the effect of such an "absolute" assignment;⁴⁶ and (d) whether a security interest in rents creates an interest that is distinct from the mortgaged real property from which the rents arise.⁴⁷ While debtors and mortgage lenders have fought most of these issues in bankruptcy courts, each issue turns primarily upon state law regarding security interests in rents. Part II chronicles the litigation surrounding these issues and discusses the manner in which the UARA would resolve them.

A. Characterization of Revenues Paid by Occupiers – Exactly What Are "Rents"?

1. Introducing the State Law Classification Dilemma

In the typical commercial mortgage loan, the lender secures the borrower's obligation by requiring the borrower to grant a security interest in the revenues paid by occupiers of the development. In many developments (*e.g.*, office buildings, industrial parks, retail shopping centers, and apartment complexes), the owner and occupiers of the development stand in landlord-tenant relationships based upon the execution of leases covering portions of the development. Because the common law traditionally treated unaccrued rents as an interest in land (an incorporeal hereditament),⁴⁸ a mortgage lender taking a security interest in the "rents" due under tenant leases must comply with real estate law's requirements to obtain and enforce that security interest. This means that the lender must have the mortgagor execute and deliver an instrument sufficient to convey an interest in "rents" (typically called an "Assignment of Leases and Rents" or simply an "Assignment of Rents"), and must record that instrument on the public land records in the county where the land is situated.

In many developments, however, the owner and the occupiers do not stand in the relationship of landlord and tenant, but in the relationship of licensor-licensee. Examples of this type of project include nursing homes,⁴⁹ parking garages,⁵⁰ golf courses,⁵¹ landfills,⁵² marinas,⁵³ stadiums or arenas,⁵⁴

45. See *infra* notes 105-124 and accompanying text.

46. See *infra* notes 125-145 and accompanying text.

47. See *infra* notes 146-162 and accompanying text.

48. *Independence Tube Corp. v. Levine* (*In re Tavern Motor Inn, Inc.*), 80 B.R. 659, 661-62 (Bankr. D. Vt. 1987); Freyermuth, *Of Hotel Revenues*, *supra* note 3, at 1481 & n.78.

49. *Dep't of Hous. & Urban Dev. v. Hillside Assocs.* (*In re Hillside Assocs. Ltd. P'ship*), 121 B.R. 23 (B.A.P. 9th Cir. 1990) (*per curiam*); *Home Sav. Ass'n of Kansas City v. Woodstock Assocs. I, Inc.* (*In re Woodstock Assocs. I, Inc.*), 120 B.R. 436 (Bankr. N.D. Ill. 1990).

50. *In re Ashford Apartments Ltd. P'ship*, 132 B.R. 217 (Bankr. D. Mass. 1991).

51. *In re GGVXX, Ltd.*, 130 B.R. 322 (Bankr. D. Colo. 1991).

student dormitories,⁵⁵ and hotels.⁵⁶ Even in a project where most occupiers are “tenants,” such as in an enclosed regional mall, certain of the occupiers may be only licensees, such as persons operating an open-area “kiosk” pursuant to agreements that permit the mall owner to relocate the kiosk within the mall’s common areas. Finally, even some projects where the occupants have executed “leases” may not be treated by courts as “leases” under landlord-tenant law. For example, the Commonwealth Court of Pennsylvania recently ruled that agreements for occupancy of self-storage facilities did not create real property interests in favor of the occupiers – even though the agreements were denominated as “leases” – because “the customers’ [control] rights are so limited that they do not take on most of the usual indicia of an interest in real property.”⁵⁷

If a development’s occupiers are licensees and not tenants, a significant classification problem arises. Are the occupiers’ payment obligations “rents” governed by real estate law, such that the lender would obtain and record an assignment of rents in the land records? Or are those obligations “accounts” subject to UCC Article 9, such that the lender would have to create a security interest in present and after-acquired accounts and perfect that interest by filing a financing statement covering accounts in the UCC filing system?⁵⁸ This classification dilemma creates a potential trap for the unwary lender. For example, a marina lender (believing that boat slip fees constitute “rents”) might document a loan transaction by having the borrower execute and record an assignment of rents – only to later face a successful judicial challenge that the boat slip fees constituted “accounts” governed by Article 9. During the 1980s and early 1990s, hotel lenders that had taken an “assignments of rents” found themselves frequent targets of such challenges, and courts frequently held that such lenders had no security interest in room revenues at all (or at best an unperfected security interest in those revenues).⁵⁹

52. *In re W. Chestnut Realty of Haverford, Inc.*, 166 B.R. 53 (Bankr. E.D. Pa. 1993).

53. *In re Northport Marina Assocs.*, 136 B.R. 911 (Bankr. E.D.N.Y. 1992).

54. *Zeeway Corp. v. Rio Salado Bank (In re Zeeway Corp.)*, 71 B.R. 210 (B.A.P. 9th Cir. 1987).

55. *Cook v. Univ. Plaza*, 427 N.E.2d 405 (Ill. Ct. App. 1981).

56. See cases cited *infra* notes 59, 63, and 64.

57. *Ne. Oxford Enters. LP v. City of Phila. Tax Review Bd.*, 834 A.2d 650, 654 (Pa. Commw. Ct. 2003). This decision addressed the issue of whether liability for the City’s use and occupancy tax on real estate properly rested upon the “lessor” or the “lessee” under these occupancy agreements. *Id.* at 651-52. The reasoning of the court’s conclusion, however, could just as easily be extrapolated to the analysis of whether the sums paid by the “lessees” under those agreements were “rents” in the nature of real property or “accounts” subject to Article 9.

58. U.C.C. § 9-102(a)(2) (2001) (“‘Account’ . . . means a right to payment of a monetary obligation, whether or not earned by performance . . . for property that has been or is to be sold, leased, licensed, assigned, or otherwise disposed of . . .”).

59. Initially, some lenders that failed to anticipate the characterization issue made hotel mortgage loans based solely upon a mortgage and an assignment of rents,

But for bankruptcy law, a prudent lender could moot the state law classification dilemma through preventive lawyering. For example, the marina lender could (a) require the borrower to execute both an assignment of rents and an Article 9 security agreement covering present and future accounts, (b) record the assignment of rents in the appropriate land records, and (c) file a financing statement covering accounts in the appropriate UCC filing office. This “belt and suspenders” approach would appear to give the lender a perfected security interest in unaccrued occupancy revenues, regardless of how state law resolved the “realty or personalty” classification question.⁶⁰

Unfortunately, the intervention of bankruptcy means that preventive drafting alone cannot completely solve the classification dilemma. As discussed earlier, Bankruptcy Code section 552(a) provides that any pre-petition security agreement covering after-acquired property does not attach to property that the bankruptcy estate acquires post-petition. By itself, section 552(a) would suggest that a lender’s security interest in pre-petition revenues would not attach to post-petition revenues. In turn, this would mean that those reve-

without taking or perfecting a security interest in accounts. Others had mortgages that contained language broad enough to grant a security interest in hotel room revenues, but (considering those revenues to be “rents”) failed to file a financing statement covering accounts so as to perfect that security interest. In bankruptcy, courts held that these lenders either had no security interest in post-petition revenues at all, or that any such security interest was unperfected. *See, e.g.,* United States v. PS Hotel Corp., 404 F. Supp. 1188, 1191-92 (E.D. Mo. 1975); *In re Gen. Associated Investors Ltd. P’ship*, 150 B.R. 756, 759-62 (Bankr. D. Ariz. 1993); *Greyhound Real Estate Fin. Co. v. Official Unsecured Creditors’ Comm. (In re Northview Corp.)*, 130 B.R. 543, 546-48 (B.A.P. 9th Cir. 1991); *In re Tri-Growth Ctr. City, Ltd.*, 133 B.R. 524, 526 (Bankr. S.D. Cal. 1991); *In re Corpus Christi Hotel Partners, Ltd.*, 133 B.R. 850, 854 (Bankr. S.D. Tex. 1991); *In re Nendels-Medford Joint Venture*, 127 B.R. 658, 663-68 (Bankr. D. Or. 1991); *In re Majestic Motel Assocs.*, 131 B.R. 523, 526 (Bankr. D. Me. 1991); *In re Shore Haven Motor Inns, Inc.*, 124 B.R. 617, 618 (Bankr. S.D. Fla. 1991); *Airport Inn Assocs., Ltd. v. Travelers Ins. Co. (In re Airport Inn Assocs., Ltd.)*, 132 B.R. 951, 954 (Bankr. D. Colo. 1990); *Sacramento Mansion, Ltd. v. Sacramento Sav. & Loan Ass’n (In re Sacramento Mansion, Ltd.)*, 117 B.R. 592, 606 (Bankr. D. Colo. 1990); *In re Oceanview/Virginia Beach Real Estate Assocs.*, 116 B.R. 57, 58-59 (Bankr. E.D. Va. 1990); *Super 8 Motel, Inc. v. M. Vickers, Ltd. (In re M. Vickers, Ltd.)*, 111 B.R. 332, 335-37 (Bankr. D. Colo. 1990); *Inv. Hotel Props., Ltd. v. New W. Fed. Sav. & Loan Ass’n (In re Inv. Hotel Props., Ltd.)*, 109 B.R. 990, 993-94 (Bankr. D. Colo. 1990); *Kearney Hotel Partners v. Richardson (In re Kearney Hotel Partners)*, 92 B.R. 95, 98-102 (Bankr. S.D.N.Y. 1988); *Victor Sav. & Loan Ass’n v. Grimm (In re Greater Atl. & Pac. Investor Group, Inc.)*, 88 B.R. 356, 359 (Bankr. N.D. Okla. 1988); *In re Ashkenazy Enters., Inc.*, 94 B.R. 645, 646-47 (Bankr. C.D. Cal. 1986).

60. Of course, the duplicate preparation and recording/filing costs involved with this “belt and suspenders” approach effectively increases the transaction costs associated with the origination of such loans. These increased costs could be avoided if commercial law could resolve the classification dilemma in a clearer fashion.

nues would not constitute the lender's cash collateral – the debtor's use of which is governed by the relatively strict limitations set forth in section 363.⁶¹

Congress drew a careful distinction, however, between *property received by the debtor post-petition* and *post-petition proceeds of pre-petition collateral*. Section 552(b) reflects this distinction, providing that a valid and properly perfected pre-petition security interest in collateral will attach to any rents, profits, and proceeds of that collateral that the debtor receives post-petition.⁶² The language of section 552(b) thus makes the classification question crucial for the commercial mortgagee. If post-petition occupancy revenues are "rents," "profits," or "proceeds" of the land, the lender's pre-petition security interest in rents continues to attach to those post-petition revenues. If the post-petition occupancy revenues are not "rents," "profits," or "proceeds" of the land, however, section 552(a) operates to extinguish the lender's interest in post-petition occupancy revenues.

Most bankruptcy cases addressing the classification question have involved security interests in hotel room charges. Prior to 1994, some decisions treated hotel room charges as the functional equivalent of tenant rents, and concluded that section 552(b) preserved a lender's properly perfected security interest in post-petition hotel room charges.⁶³ Most courts, however, con-

61. The Bankruptcy Code provides that the trustee/debtor-in-possession "may not use, sell, or lease cash collateral" unless the secured creditor consents or the court so authorizes following notice and a hearing. 11 U.S.C. § 363(c)(2) (2000). The trustee/debtor-in-possession must "segregate and account for any cash collateral" in its possession and control. *Id.* § 363(c)(4). Further, the bankruptcy court cannot authorize the use of cash collateral in any event unless the trustee/debtor-in-possession can provide "adequate protection" of the secured creditor's interest in that cash collateral, *id.* § 363(e), or unless the court concludes that allowing such use would be consistent with the "equities of the case." *Id.* § 552(b).

62. Prior to 1994, § 552(b) read as follows:

[I]f the debtor and [the] secured party enter into a security agreement before the commencement of the case and if the . . . security agreement extends to property of the debtor acquired before the commencement of the case and to *proceeds, product, offspring, rents, or profits of such property*, then such security interest extends to such proceeds, product, offspring, rents, or profits acquired by the estate after the commencement of the case to the extent provided by such security agreement and by applicable non-bankruptcy law

An Act to Establish a Uniform Law on the Subject of Bankruptcies, Pub. L. No. 95-598, § 5529 (1978) (prior to 1994 amendment) (emphasis added).

63. See, e.g., *Fin. Sec. Assurance, Inc. v. Tollman-Hundley Dalton, L.P.*, 74 F.3d 1120 (11th Cir. 1996); *Fin. Sec. Assurance, Inc. v. Days Cal. Riverside Ltd. P'ship (In re Days Cal. Riverside Ltd. P'ship)*, 27 F.3d 374 (9th Cir. 1994); *T-H New Orleans Ltd. P'ship v. Fin. Sec. Assurance, Inc. (In re T-H New Orleans Ltd. P'ship)*, 10 F.3d 1099 (5th Cir. 1993); *Great-W. Life & Annuity Assur. Co. v. Parke Imperial Canton, Ltd.*, 177 B.R. 843 (N.D. Ohio 1994); *Bellevue Place Assocs. v. Caisse Centrale Des Banques Populaires (In re Bellevue Place Assocs.)*, 173 B.R. 1009 (Bankr. N.D. Ill. 1994); *In re S.F. Drake Hotel Assocs.*, 131 B.R. 156, 158-61 (Bankr. N.D.

cluded that post-petition hotel room charges were after-acquired accounts (personal property) and were neither “rents,” “profits,” nor “proceeds” of the land.⁶⁴ These courts typically applied the formalistic reasoning that room charges could not be “rents” because hotel guests were not “tenants.” As a result, many bankruptcy courts routinely invalidated lenders’ claimed interests in post-petition hotel room charges.

2. Analysis of (and Potential Solutions to) the Classification Dilemma

Formalistic invalidation of a hotel lender’s interest in post-petition room charges is inappropriate, as hotel room charges are functionally identical to “rents” paid by tenants under apartment, office, or industrial leases.⁶⁵ In economic terms, the developer’s right to payments under its contracts with occupiers – whether tenants or licensees – constitutes an economic return upon the productive capacity of the development, as the occupiers of the development consume that productive capacity over time.⁶⁶ In this regard, rents, hotel room charges and other forms of occupancy revenues are fundamentally analogous to “proceeds” as that term is used in UCC Article 9.⁶⁷ Thus, when used as collateral to secure a mortgage loan, all post-petition revenues paid for occupancy of commercial real estate should fit within the scope of post-petition revenues protected by section 552(b).

Cal. 1991), *aff’d*, 147 B.R. 538 (N.D. Cal. 1992); Mid-City Hotel Assocs. v. Prudential Ins. Co. of Am. (*In re* Mid-City Hotel Assocs.), 114 B.R. 634, 638-42 (Bankr. D. Minn. 1990); Great-W. Life Assurance Co. v. Raintree Inn, 837 P.2d 267 (Colo. App. 1992); Travelers Ins. Co. v. First Nat’l Bank, 621 N.E.2d 209 (Ill. App. 1993)

64. See, e.g., *In re* Northview Corp., 130 B.R. at 548; Casco N. Bank, N.A. v. Green Corp. (*In re* Green Corp.), 154 B.R. 819 (Bankr. D. Me. 1993); *In re* Airport Inn Assocs., Ltd., 132 B.R. at 960; *In re* Majestic Motel Assocs., 131 B.R. 523; *In re* Shore Haven Motor Inn, Inc., 124 B.R. 617; *In re* Corpus Christi Hotel Partners, Ltd., 133 B.R. at 854-55; *In re* Sacramento Mansion, Ltd., 117 B.R. at 602-07; *In re* Inv. Hotel Props., Ltd., 109 B.R. at 994-97.

65. See, e.g., Freyermuth, *Of Hotel Revenues*, *supra* note 3; R. Wilson Freyermuth, *The Circus Continues – Security Interests in Rents, Congress, the Bankruptcy Courts, and the “Rents Are Subsumed in the Land” Hypothesis*, 6 J. BANKR. L. & PRAC. 115 (1997) [hereinafter Freyermuth, *The Circus Continues*].

66. Freyermuth, *The Circus Continues*, *supra* note 65, at 126-27.

67. *Id.* This is not to suggest that they are actually “proceeds” as defined in Article 9. Under Article 9, “proceeds” constitutes “whatever is acquired upon the sale, lease, license, exchange, or other disposition of collateral.” U.C.C. § 9-102(a)(64)(A) (2001). In turn, Article 9 defines “collateral” to mean “the property subject to a security interest,” *id.* § 9-102(a)(12), and this would exclude land, because by definition an Article 9 security interest can arise only in personal property or fixtures. *Id.* § 1-201(b)(35). Thus, because land cannot be Article 9 collateral, the rents cannot constitute Article 9 “proceeds.” Nevertheless, they are certainly in the nature of proceeds, as manifested by the fact that equipment lease rentals do constitute Article 9 proceeds of the equipment.

Recognizing that bankruptcy court decisions in hotel cases unjustly penalized lenders, Congress amended section 552(b) in 1994 to provide explicit protection for a lender's interest in post-petition "fees, charges, accounts, or other payments for the use or occupancy of rooms and other public facilities in hotels, motels, or other lodging properties."⁶⁸ This amendment effectively mooted the classification dilemma with respect to hotels and other "lodging properties." Unfortunately, the amendment did not address a wide variety of other income-generating projects – such as golf courses,⁶⁹ parking garages,⁷⁰ marinas,⁷¹ landfills,⁷² and stadiums or arenas⁷³ – in which the end-users also are not "tenants."

As a result, the amended section 552(b) does not completely solve the classification dilemma. For example, if the revenues from a parking garage are "rents" within the meaning of state law and section 552(b), then a lender's assignment of rents on the garage would attach to post-petition revenues from the garage. However, if they are "accounts," then the lender runs a heightened risk that its security interest in post-petition revenues from the garage – even if properly documented in the first instance – could be cut off by virtue of section 552(b).⁷⁴ Accordingly, the basic classification dilemma remains: what

68. 11 U.S.C. § 552(b)(2) (as amended in 1994).

69. Most courts have concluded that greens fees do not constitute "rents," "profits," or "proceeds" of the land entitled to protection under § 552(b). *See, e.g., In re McKim*, 217 B.R. 97 (Bankr. D.R.I. 1998); *In re Everett Home Town Ltd. P'ship*, 146 B.R. 453 (Bankr. D. Ariz. 1992); *In re McCann*, 140 B.R. 926 (Bankr. D. Mass. 1992); *In re GGVXX, Ltd.*, 130 B.R. 322 (Bankr. D. Colo. 1991)

70. *In re Ashford Apartments Ltd. P'ship*, 132 B.R. 217 (Bankr. D. Mass. 1991) (parking fees in nature of "rents").

71. *Compare In re Northport Marina Assocs.*, 136 B.R. 911 (Bankr. E.D.N.Y. 1992) (fees paid by marina users for assigned slip for periods of six months or more were in nature of "rents," while fees paid by transitory users were "accounts"), with *First Am. Bank of Va. v. Harbor Pointe Ltd. P'ship (In re Harbour Pointe Ltd. P'ship)*, 132 B.R. 501 (Bankr. D.D.C. 1991) (fees generated by marina treated as "rents") and *In re Hamlin's Landing Joint Venture*, 77 B.R. 916 (Bankr. M.D. Fla. 1987) (same).

72. *In re W. Chestnut Realty of Haverford, Inc.*, 166 B.R. 53 (Bankr. E.D. Pa. 1993), *aff'd*, 173 B.R. 322 (E.D. Pa. 1994).

73. *See, e.g., Klingner v. Pocono Int'l Raceway, Inc.*, 433 A.2d 1357 (Pa. Super. 1981); *Zeeway Corp. v. Rio Salado Bank (In re Zeeway Corp.)*, 71 B.R. 210 (B.A.P. 9th Cir. 1987).

74. Without question, the most preferable solution to the classification dilemma would be to say that post-petition garage revenues (and other sums paid by non-tenant users and occupiers) are both "accounts" under state law (UCC Article 9) and "rents" or "proceeds" under federal law as those terms are used in Code section 552(b). This treatment makes sense in economic terms, see *supra* notes 65-67 and accompanying text, and there is support in the legislative history of the Bankruptcy Code for an expansive definition of these terms. *See* H.R. Rep. No. 95-595 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6332-33 ("The term 'proceeds' is not limited to the technical definition of that term in the U.C.C., but covers any property into which property

is the fundamental character of the income produced by the occupancy of commercial real estate?

The law could simply choose to retain the formalistic rents/accounts distinction recognized by the weight of bankruptcy court authority and limit the term “rents” to sums payable by “tenants.” Under this approach, occupancy revenue would constitute “rents” only when produced by projects like office buildings, shopping centers, and apartments – and only when payable by an occupier that in fact held a possessory estate in the land. All other occupancy revenues paid by non-tenants – even though such revenues might be paid in exchange for the right to occupy or use land – would constitute personal property collateral (“accounts”) within the scope of UCC Article 9. This approach, however, not only retains the existing “trap for the unwary” – *i.e.*, using an “assignment of rents” when the occupancy revenues do not constitute “rents” – but also subjects the mortgagee to the risk of losing its security interest in post-petition occupancy revenues that are not “rents” under section 552(a).

By contrast, previous law reform efforts and commentators have advanced two alternative solutions to the classification dilemma. First, the law could treat the right to payment under any occupancy agreement for land – including tenant leases – as an “account” subject to Article 9 of the Uniform Commercial Code. Second, the law could maintain the traditional realty (rents) vs. personalty (accounts) distinction, yet define “rents” more broadly to include sums payable by occupiers of land other than tenants.

a. Rents as Article 9 Collateral?

From the date of its original enactment, Article 9 has excluded from its scope liens upon real property. Section 9-109(d)(11) provides that Article 9 “does not apply to . . . the creation or transfer of an interest in or lien on real property, including a lease or rents thereunder.”⁷⁵ As a result, in a commercial real estate mortgage transaction covering real property in which the end-users occupy the property under leases, the lender must comply with the requirements of mortgage law – *i.e.*, by obtaining an assignment of rents and recording that assignment on the public land records.⁷⁶

Article 9’s exclusion of a lien upon rents stands in stark contrast to the manner in which Article 9 treats a security assignment of a vendor’s right to payment arising out of a contract for the sale of land. Under pre-revision Article 9, the rights to payment arising out of a contract for the sale of land con-

subject to the security interest is converted.”). Unfortunately, as the hotel cases (cited *supra* note 64) demonstrate, bankruptcy courts have tended to give the terms “rents” and “proceeds” as used in section 552(b) the same meaning given to them by state law – and thus have refused to treat these sums as both “accounts” under state law and “proceeds” under section 552(b).

75. U.C.C. § 9-109(d)(11) (2001); *see also id.* § 9-104(j) (1972 version).

76. *See supra* note 48 and accompanying text.

stituted a "general intangible" under Article 9,⁷⁷ and most courts concluded that an assignment of a vendor's interest under an installment land contract created a security interest in a general intangible subject to the provisions of Article 9.⁷⁸ Under revised Article 9, the vendor's right to payment under a contract for the sale of land now constitutes an "account," which is defined to include any "right to payment of a monetary obligation, whether or not earned by performance . . . for property that has been or is to be sold."⁷⁹ As a result, if *V* sells Blackacre to *P* by installment land contract, and later *V* borrows money from *M* and assigns to *M* as security its rights under the Blackacre installment contract, *M*'s collateral is an "account." To create and perfect a security interest in the vendor's right to payment under the contract, *M* must have *V* execute a security agreement granting a security interest in this "account" and file a financing statement covering the account in the appropriate UCC filing office.⁸⁰ Even though the right to payment arises out of a contract for the sale of real property, commercial law treats this right to payment as personal property collateral.

77. Under pre-revision Article 9, the term "account" was defined as "any right to payment for goods sold or leased or for services rendered . . ." U.C.C. § 9-106 (1972 text). An installment land contract vendor's right to installment payments could not constitute an account under that definition, as "goods" did not include land. *Id.* § 9-105(1)(h) (1972 text) ("'Goods' includes all things which are movable at the time the security interest attaches . . ."). As a result, courts held that the installment land contract vendor's rights to payment fell within the category of "general intangibles," which was Article 9's "catch-all" category for property that fit no other Article 9 definition. *See id.* § 9-106 (1972 text) ("'General intangibles' means any personal property (including things in action) other than goods, accounts, chattel paper, documents, instruments, investment property, rights to proceeds under written letters of credit, and money.").

78. *See, e.g.,* Heide v. Mading King County Enters., Inc. (*In re Heide*), 915 F.2d 531, 533-34 (9th Cir. 1990) (applying Washington law); Frearson v. Wingold (*In re Equitable Dev. Corp.*), 617 F.2d 1152, 1155-57 (5th Cir. 1980) (applying Florida law); I.A. Durbin, Inc. v. Jefferson Nat'l Bank (*In re I.A. Durbin, Inc.*), 46 B.R. 595, 599 (Bankr. S.D. Fla. 1985); N. Acres, Inc. v. Hillman State Bank (*In re N. Acres, Inc.*), 52 B.R. 641, 644-47 (Bankr. E.D. Mich. 1984); Borock v. N.B.D. Dearborn Bank (*In re D.J. Maltese, Inc.*), 42 B.R. 589, 591-92 (Bankr. E.D. Mich. 1984); Nazar v. Southern (*In re Southern*), 32 B.R. 761, 764-65 (Bankr. D. Kan. 1983); Castle Rock Indus. Bank v. S.O.A.W. Enters., Inc. (*In re S.O.A.W. Enters., Inc.*), 32 B.R. 279, 284-86 (Bankr. W.D. Tex. 1983); Gemini at Dadeland, Ltd. v. Biscayne Bank (*In re Gemini at Dadeland Ltd.*), 24 B.R. 57, 58 (Bankr. S.D. Fla. 1982); Sw. Bank v. Southworth (*In re Southworth*), 22 B.R. 376, 378-79 (Bankr. D. Kan. 1982); Sec. Bank v. Chiapuzio, 747 P.2d 335, 336-43 (Or. 1987); Citicorp Pers.-to-Pers. Fin. Ctr., Inc. v. Fremont Nat'l Bank, 738 P.2d 29, 31-32 (Colo. App. 1987); Crichton v. Himlie Props., Inc., 713 P.2d 108, 110 (Wash. 1986); Freeborn v. Seattle Trust & Sav. Bank (*In re Freeborn*), 617 P.2d 424, 427-29 (Wash. 1980).

79. U.C.C. § 9-102(a)(2) (2001).

80. *Id.* § 9-310(a).

In classifying the interests arising from an installment land contract, commercial law has thus separated the vendor's interest in the land itself from the vendor's contractual rights to payment under the contract. To this extent, the installment land contract provides a plain and functional analogue to the lease. The vendee's promise to perform an installment land contract gives the vendee an interest in land; likewise, the lessee's promise to perform the terms of its lease gives the lessee an interest in land. While the vendor retains legal title to the land during the term of the contract, commercial law treats the vendor's contract rights to payment (if assigned as security for a debt) as personal property in the nature of an account. To some extent, this classification reflects that the assignee's primary concern is to obtain security in the vendee's installment payments. Likewise, one could separate the assignment of a lease into real and personal property components, as commercial law has done with the installment land contract. Security law could characterize the assignment of a lease as transferring both an interest in realty (the lessor's reversionary interest in the land) and an interest in the lessor's contractual rights under the lease (including the lessor's right to collect the lessee's contract payments) – with the latter interest (the rents) characterized as personal property.

Further, because a developer's right to collect occupancy payments constitutes a return on the economic value of the development, Article 9 and its proceeds rule provide a structural framework that is frankly superior to the traditional common law of real property. In defining the term "proceeds," Article 9's drafters did not distinguish between sums received upon sale of collateral and sums received upon the lease of collateral – both sums constitute "proceeds" under Article 9, with the secured party's interest in the collateral following automatically into identifiable proceeds of the collateral.⁸¹ Article 9's proceeds coverage rules provide equivalent treatment of a lender's interest in the economic return generated by collateral, whether that return comes from a one-time sale, an installment sale, or a lease.

A decade ago, Julia Forrester and I proposed in separate articles that bringing rents within the scope of Article 9 would provide greater coherence to commercial law, by unifying the treatment of an assignment of rents with the treatment of security in accounts receivable.⁸² Such a characterization would permit parties to mortgage transactions to use now-familiar Article 9 rules as a framework for the creation, perfection and enforcement of any security interest in the right to collect occupancy revenues generated by land.⁸³

81. See *supra* note 2 and accompanying text.

82. Freyermuth, *Of Hotel Revenues*, *supra* note 3, at 1520; Julia Patterson Forrester, *A Uniform and More Rational Approach to Rents as Security for the Mortgage Loan*, 46 RUTGERS L. REV. 349 (1993).

83. Such an approach certainly would have eliminated the confusion about what was necessary for a lender to "perfect" its security interest in rents in the bankruptcy context. This confusion is discussed *infra* notes 105-124. This approach might also have had the virtue of reducing transaction costs in some jurisdictions, to the extent

One might object to treating rents as personal property collateral subject to Article 9 on several grounds. First, such a change would be disruptive of customary commercial practices and expectations. For example, treating rents as personal property collateral would obligate those searching title to land to look outside the land records and into the UCC filing system for pertinent title information (the existence of an assignment of rents). Second, such a change would create systems problems given the different operations of real and personal property filing systems – compare, for example, the effectively unlimited duration of a recorded and uncanceled assignment of rents (necessary because mortgage debts usually have a maturity in excess of 5 years at origination) and the maximum five-year life span of an ordinary Article 9 financing statement. These “problems,” however, are red herrings. A purchaser’s “due diligence” investigation in a commercial real estate transaction already commonly includes a search of the Article 9 records, as commercial real estate transactions commonly include the transfer of (or creation of a security interest in) some personal property located on or related to the land. Further, Article 9 has already incorporated rules for extending the duration of financing statements where the standard 5-year period of effectiveness is insufficient.⁸⁴

In reality, the telling objection to treating rents as Article 9 collateral is political. Experience suggests treating rents as personal property collateral is unlikely to obtain traction in law reform circles. In 1958, the drafters of Article 9 excluded assignments of leases and rents from Article 9’s scope, ostensibly to avoid objections from the real estate bar and to facilitate the Article 9’s nationwide enactment.⁸⁵ Revised Article 9, which became effective in July 2001, retained this exclusion – and at this point, there appears to be little impetus for further revision to Article 9.⁸⁶ Thus, even though treating rents as personal property collateral may provide the cleanest and most coherent solution to the classification dilemma, the UARA’s drafting committee chose to leave rents within the domain of real estate law.

b. A Broader Definition of Rents as Realty

The Restatement (Third) of Property – Mortgages addressed the classification dilemma by retaining the concept of “rents” as an interest in realty, but defining the term more broadly to include “the proceeds payable by a lessee, licensee, or other person for the right to possess, use, or occupy the real prop-

that filing costs for a one-page Article 9 financing statement are lower than the costs incurred to record multi-page assignments of rents on the land records.

84. See U.C.C. § 9-515(f) (2001) (if debtor is a transmitting utility, filed financing statement remains effective until it is terminated); § 9-515(b) (financing statement filed in connection with a public-finance transaction or a manufactured-home transaction is effective for 30 years after date of filing).

85. U.C.C. § 9-104(j) (1972 text).

86. U.C.C. § 9-109(d)(13) (2001).

erty of another.”⁸⁷ The comments to Section 4.2 emphasize the functional nature of this definition:

The term “rents,” as used in this section, encompasses also “issues and profits” of real estate. Moreover, the definition includes not only rents and royalties that arise out of lease relationships, but also other proceeds that are paid primarily for the possession, occupancy, or use of real property. To the extent that a lease requires a tenant to pay a pro-rata share of mortgagor’s real estate taxes or common area expenses, such obligations are treated as “rents.” Moreover, the definition includes hotel room charges as well as fees generated from most parking facilities. On the other hand, the definition does not encompass accounts receivable and other proceeds that result primarily from the sale of goods or services. Security interests in such proceeds are solely within the purview of the Uniform Commercial Code.⁸⁸

The primary virtue of the Restatement’s definition is its functional appeal. As discussed above, the economic similarity between tenant rents and occupancy charges paid by licensees supports a rule that would accord them equivalent legal treatment. For example, the Restatement’s functional definition would avoid the “trap for the unwary” into which numerous hotel lenders fell in the 1980s (*e.g.*, taking an “assignment of rents” only to have the court conclude that hotel room charges were not “rents” at all).

Still, as its drafters conceded, the Restatement’s functional definition left residual uncertainty about the classification of some sums generated by commercial real estate. The illustrations contained in the comments to Restatement Section 4.2 suggested that revenues paid by parking patrons in a parking garage would constitute “rents” from the garage,⁸⁹ but that gate receipts paid by visitors to a racetrack would not constitute “rents” because they “derive[] primarily from the entertainment provided to race track customers.”⁹⁰ These examples suggested that a “land vs. services” analysis was implicit in resolving the rents/non-rents classification dilemma. Yet this land/services distinction still leaves residual uncertainty regarding the revenues produced by such projects as golf courses, landfills, marinas, theaters and stadia, as it appears to place the burden on courts to make case-by-case

87. RESTATEMENT (THIRD) OF PROP.: MORTGAGES § 4.2(a) (1997).

88. *Id.* cmt. e.

89. “Because receipts from parking patrons primarily represent fees paid for the right to park motor vehicles on Mortgagor’s real estate, they constitute rents and Mortgagee has the right to collect them until the mortgage obligation is satisfied.” *Id.* cmt. f, illus. 9.

90. “Because the gate receipts are derived primarily from the entertainment provided to race track customers, they do not constitute rents and Mortgagee has no right to collect them.” *Id.* cmt. f, illus. 8.

judgments about the extent to which occupancy revenues are “primarily” traceable to the “use of land” as opposed to “services” provided by the operator.

At the margin, courts would face significant practical obstacles in making such judgments.⁹¹ First, would basing the classification question upon the land/services distinction justify or require parties to compile and analyze historical information concerning the developer’s capital and operational costs in order to characterize the revenues as “rent”? Second, the extent to which different occupiers are concerned about occupying space as opposed to receiving services is a function of each occupier’s respective preferences – but these may differ substantially from user to user and from situation to situation. In this respect, one might consider the greens fees generated by a golf course. Some courses can command high greens fees only because of the significant capital investment made by the developer to construct a challenging golf course out of an otherwise unremarkable (and not particularly valuable) piece of land. Other courses may command high greens fees precisely because of the underlying characteristics of the land itself (e.g., Pebble Beach, which can command high greens fees because of its spectacular setting). Thus, it is not clear exactly how a court would go about determining whether greens fees constituted “rents” under the Restatement’s functional definition – and thus the Restatement’s functional definition may not provide a sufficiently clear solution to the classification dilemma.

3. The Classification Dilemma and the UARA

The UARA adopts a two-fold strategy to address the classification dilemma. First, the UARA follows the Restatement approach of broadening the scope of “rents,” defining the term to include “sums payable for the right to possess or occupy, or for the actual possession or occupancy of, real property of another person.”⁹² This definition would treat as “rents” sums payable by one who has the right to occupy the real property of another in a fashion that is essentially exclusive in nature. Thus, for example, the UARA would treat hotel room charges as “rents,” as the hotel guest’s occupancy is in practical terms exclusive – the guest’s occupancy effectively prevents its enjoyment by other third persons – even if the guest’s interest does not rise to the level of a nonfreehold estate.

As discussed above, however, this approach leaves it unclear whether sums paid by certain users or occupiers – such as golf course greens fees or boat slip fees – constitute rents. To address this uncertainty, the UARA takes an indirect approach to solving the classification trap. The UARA establishes a baseline rule that a mortgage *automatically* creates an assignment of rents,

91. For more detailed discussion of the difficulties presented by the land-services distinction, see Freyermuth, *Of Hotel Revenues*, *supra* note 3, at 1512-24.

92. National Conference of Commissioners on Uniform State Laws, Uniform Assignment of Rents Act § 2(12)(A) (2005) [hereinafter UARA].

unless the mortgage itself provides otherwise.⁹³ In this regard, the UARA adopts a default rule comparable to the “proceeds” rules of UCC Article 9.⁹⁴ Given the economic equivalence between rents and proceeds,⁹⁵ this default rule makes functional sense. Furthermore, because parties to most commercial mortgage loans typically include an express assignment of rents, the UARA’s baseline rule merely captures the expected bargain of the parties to the mortgage transaction (in the same way that Article 9’s proceeds rules reflect the presumed *ex ante* bargain of debtor and secured party).

As a practical matter, the UARA’s default rule should enable most prudent mortgagees to moot the classification trap. For example, consider a loan to be secured by a mortgage on a marina. Under the present approach, the lender must make a judgment whether boat slip charges would constitute rents or accounts and must obtain and file/record the proper documentation depending upon that judgment. If the lender takes and records an assignment of rents but does not obtain and perfect a security interest in accounts, the lender is subject to the risk of an *ex post* determination that the slip fees are accounts not covered by the assignment of rents. If the lender obtains and perfects a security interest in accounts, but does not take an assignment of rents, the lender is subject to the risk of an *ex post* determination that the slip fees are rents not covered by the security agreement. To the extent that the lender cannot resolve the residual uncertainty, the lender must both take and record an assignment of rents and obtain and perfect a security interest in accounts – marginally increasing the transaction costs of the loan. By contrast, under the UARA’s default rule, the lender need not take and record an express assignment of rents. The lender could take and record a mortgage on the land and obtain and perfect a security interest in the borrower’s accounts. If the court later determines that the boat slip fees constitute “rents,” the lender’s recorded mortgage on the land is sufficient to provide the lender with

93. UARA § 4(a) (“An enforceable security instrument creates an assignment of rents arising from the real property described in the security instrument, unless the security instrument provides otherwise.”).

During the UARA drafting committee’s discussions, a concern was raised that UARA § 4(a) would essentially reject the lien theory of mortgage law. Obviously, UARA § 4(a) does not have that effect. If a lien theory state enacts UARA, a mortgage in that state will only create a lien on the mortgaged land; it will not affect any transfer of legal title to the land prior to foreclosure. In a lien theory state, the enactment of UARA would only alter the law with respect to the creation of a lien on rents – making such a lien automatic (unless the mortgage specified otherwise) rather than requiring the granting of a separate assignment of rents. *See supra* notes 35-36 and accompanying text. Further, UARA § 4(a) only creates a lien on the rents as security for the mortgage debt.

94. U.C.C. §§ 9-203(f), 9-315(a)(2) (2001). It is also worth noting that this result is also consistent with the provisions of the Uniform Land Security Interest Act, promulgated by NCCUSL in 1985. *See* Uniform Land Security Interest Act §§ 111(20), 210(c) & cmt. 3.

95. *See supra* notes 65-67 and accompanying text.

a perfected security interest in rents. In this way, the UARA will obviate the need for (and the expense of) preparing and recording an express assignment of rents in those cases where the classification of the property revenues is unclear. Furthermore, by broadening the definition of “rents” and making it clear that the “rents” are analogous to “proceeds,” the UARA should increase the likelihood that a lender’s interest in post-petition occupancy revenues is preserved under Bankruptcy Code § 552(b).⁹⁶

The UARA’s baseline rule should not prove disruptive of lender and borrower expectations in the commercial setting. First, in nearly all commercial mortgage transactions, mortgage documentation includes an express assignment of rents (either in the mortgage itself, in a separate document, or both). Second, this new baseline rule will not apply to mortgages signed and delivered before the UARA takes effect.⁹⁷

The UARA’s impact upon residential mortgage transactions is more nuanced. Most residential mortgage forms in current use (such as the Fannie Mae/Freddie Mac single-family instruments) do not contain an express assignment of rents. In a title-theory state, the lack of an express assignment of rents is not significant, as the mortgagee’s legal title would permit the mortgagee to collect rents after default (unless the mortgage provided otherwise).⁹⁸ But in a lien-theory state, a mortgage that does not contain an express assignment of rents traditionally has not been viewed as creating a security interest in rents – effectively preventing the mortgagee from obtaining control of rentals from the land until the mortgagee can complete a foreclosure or (in exceptional cases) obtain the appointment of a receiver.⁹⁹

The UARA’s baseline rule would change this result and grant the residential mortgagee an automatic lien upon rents (unless the mortgage provided to the contrary). For two important reasons, however, this change should have no negative effects on residential mortgagors. First, rents typically will not accrue in cases where the borrower occupies the mortgaged real property as its primary residence. This means that in the overwhelming majority of residential mortgages, any implicit assignment of rents created by the UARA will be of no practical relevance. Second, in the rare case where rents would arise from such property – e.g., where a mortgagor occupies the mortgaged premises as a residence but “rents out” the basement or the attic to a tenant or boarder – the Act’s remedial mechanisms for enforcing the assignee’s interest in rents by notification¹⁰⁰ are not available if the assignee holds a security interest in rents solely by virtue of the UARA’s baseline rule.¹⁰¹ Without ob-

96. See *supra* notes 65-74 and accompanying text.

97. UARA § 19(c). Thus, already existing mortgages that do not contain an express assignment of rents will not automatically create a security interest in rents.

98. See *supra* notes 33-34 and accompanying text.

99. See *supra* notes 35-36 and accompanying text.

100. See *infra* parts IIIB and IIIC.

101. UARA §§ 8(d), 9(g). See *infra* notes 191-200 (enforcement by notification to assignor), notes 201-212 (enforcement by notification to tenants).

taining an express assignment of rents, a residential mortgagee thus could not obtain control over any rents actually accruing from a mortgagor-occupied residence unless the mortgagee could demonstrate equitable circumstances justifying the appointment of a receiver for the property. Because courts have rarely granted receiverships for mortgagor-occupied residential real property, the practical negative impact of the UARA upon residential mortgages will be minimal at best.¹⁰²

In fact, by negating the documentary trap for the unwary, the UARA's baseline rule should operate to the benefit of financing sellers of real property – many of whom may well act without benefit of legal counsel (and thus may fail to obtain an express assignment of rents).¹⁰³ For example, if a seller of a vacation home sells the home but takes back a purchase money mortgage without an express assignment of rents, the seller could find itself in substantial difficulty if the buyer subsequently chooses to lease (rather than occupy) the home and later files for bankruptcy. Under the UARA, the financing seller would obtain a security interest in rents automatically (unless the mortgage provided otherwise), and this would provide the seller with recourse to the post-petition rents in the event of buyer's bankruptcy.

Finally, the UARA's baseline rule would also have relevance if the United States were to adopt the United Nations Convention on the Assignment of Receivables in International Trade. Under article 4.5(a) of that Convention, the priority choice of law rules for assignments of receivables do not affect the priority of an interest in rents under the law of the state in which the related real property is located if under that law an interest in the real property conveys an interest in the rents. A state which enacts the UARA would have the benefit of article 4.5(a).¹⁰⁴

B. "Perfection" of a Security Interest in Rents.

1. Judicial Conflation of "Perfection" and "Enforcement"

Using the bankruptcy trustee's "strong-arm" powers as expressed in Bankruptcy Code section 544(a), a debtor-in-possession can invalidate or "avoid" any security interest that a judgment lien creditor (as to personal property) or a bona fide purchaser (as to non-fixture real property) could have avoided under state law as of the petition date.¹⁰⁵ The strong-arm power permits a debtor-in-possession to invalidate an unperfected security interest in

102. *E.g.*, *Keybank Nat'l Ass'n v. Michael*, 737 N.E.2d 834 (Ind. Ct. App. 2000) ("A receiver may be appointed by the court . . . if, at the time the motion is filed, the property is not occupied by the owner as the owner's principal residence . . .").

103. UARA § 4 cmt. 1.

104. UARA § 4 cmt. 1. I am grateful to Ed Smith for highlighting the relationship between UARA § 4(a) and article 4.5 of UNCITRAL.

105. 11 U.S.C. § 544(a) (2000).

property of the bankruptcy estate. For example, if a creditor had taken a security interest in the debtor's inventory but had failed to file an Article 9 financing statement sufficient to perfect that interest, the creditor's unperfected security interest in inventory would be subordinate under state law to the rights of a creditor with a judgment lien against that inventory.¹⁰⁶ Upon the debtor's bankruptcy filing, section 544(a) would thus permit the debtor-in-possession to exercise the rights of a lien creditor – enabling the debtor-in-possession to invalidate the creditor's unperfected security interest in the inventory and use the proceeds of that inventory to fund its reorganization effort.

In the 1980s and early 1990s, bankruptcy courts struggled mightily over the impact of section 544(a) upon a mortgagee's right to post-petition rents under an assignment of rents. This struggle primarily arose due to the confusion generated by the disparate vocabularies of mortgage law and Article 9. Under Article 9, a secured party obtains a security interest in collateral by having the debtor execute a security agreement describing that collateral,¹⁰⁷ and "perfects" that security interest by filing an Article 9 financing statement describing the collateral.¹⁰⁸ By "perfecting" its security interest, the Article 9 secured party makes that interest enforceable against subsequent creditors – such as lien creditors (and thus the trustee in bankruptcy). If the secured party has a properly perfected security interest prior to the petition date, it is irrelevant whether the secured party had taken any steps to enforce that security interest prior to bankruptcy. The perfected security interest continues to remain effective against the collateral and the debtor cannot avoid that security interest using its strong-arm avoidance power.

By contrast, mortgage law did not customarily use the term "perfection." Instead, real estate law focused upon "recording" – the idea that "recording" a document on the public land records made the interest created in that document valid against subsequent creditors and bona fide purchasers. Analytically, of course, "recording" in this sense is similar to the Article 9 concept of perfection. One could thus argue that if a mortgage lender had taken and properly recorded an assignment of leases and rents prior to bankruptcy, the mortgage lender's interest in rents would be generally enforceable against third parties. Under this analysis, the debtor could not avoid the mortgage lender's security interest in rents under section 544(a), and the mortgage lender would retain its interest in post-petition rents under section 552(b). A number of courts in fact adopted this analytical approach, properly treating post-petition rents as the lender's cash collateral so long as the mortgagee had

106. U.C.C. § 9-317(a)(2) (2005) ("A security interest . . . is subordinate to the rights of . . . a person that becomes a lien creditor before . . . the security interest . . . is perfected.").

107. *Id.* § 9-203(b)(3).

108. *Id.* § 9-310(a).

properly recorded its assignment of rents prior to bankruptcy.¹⁰⁹ By contrast, numerous bankruptcy courts invalidated security interests in post-petition rents in cases in which lenders had taken no “affirmative steps” to enforce those interests prior to the debtor’s bankruptcy petition.

To understand these decisions and how they conflated “perfection” or “enforceability” with “enforcement,” it is useful to revisit the distinction between the lien and title theory of mortgages. Under the title theory, the mortgagee held legal title to the land (and unaccrued rents) by virtue of the mortgage, even prior to default. By contrast, under the lien theory, a mortgage by itself gave the mortgagee only a security interest in the land rather than legal title – and thus gave the mortgagee no interest in unaccrued rents until such time as the mortgagee completed a foreclosure, became a mortgagee in possession, or obtained the appointment of a receiver for the land.¹¹⁰ Of course, if the mortgagee claims a security interest in rents by virtue of a separate assignment of leases and rents, then the legal constraints on the mortgagee’s implicit right to rents (*i.e., by virtue of the mortgage itself*) should be irrelevant. Nevertheless, a number of state court decisions conflated these two situations, holding that even a separate assignment of rents was not effective until the mortgagee took affirmative steps after default to enforce that assignment. The language of the Texas Supreme Court in *Taylor v. Brennan*¹¹¹ is perhaps the best demonstration of this analysis:

Texas follows the lien theory of mortgages. Under this theory the mortgagee is not the owner of the property and is not entitled to its possession, rentals or profits. Thus, it has become a common practice to include in the deed of trust, or in a separate instrument, terms assigning to the mortgagee the mortgagor’s interest in all rents falling due after the date of the mortgage as additional security for payment of the mortgage debt.

The Texas cases addressing rentals assigned as security have followed the common law rule that an assignment of rentals does not

109. *O’Neal Steel, Inc. v. EB Inc. (In re Millette)*, 186 F.3d 638 (5th Cir. 1999); *Steinberg v. CrossLand Mortgage Corp. (In re Park at Dash Point L.P.)*, 985 F.2d 1008, 1011 (9th Cir. 1993); *Vienna Park Props. v. United Postal Sav. Ass’n (In re Vienna Park Props.)*, 976 F.2d 106, 112-15 (2d Cir 1992); *J.H. Streiker & Co. v. SeSide Co. (In re SeSide Co.)*, 152 B.R. 878, 884-85 (Bankr. E.D. Pa. 1993); *In re Northport Marina Assocs.*, 136 B.R. 911, 917-18 (Bankr. E.D.N.Y. 1992); *In re White Plains Dev. Corp.*, 136 B.R. 93, 95 (Bankr. S.D.N.Y. 1992); *In re Rancourt*, 123 B.R. 143, 147 (Bankr. D.N.H. 1991); *In re Somero*, 122 B.R. 634, 638-39 (Bankr. D. Me. 1991); *In re Raleigh/Spring Forest Apts. Assocs.*, 118 B.R. 42, 45 (Bankr. E.D.N.C. 1990); *Nw. Nat’l Life Ins. Co. v. Metro Square (In re Metro Square)*, 106 B.R. 584, 587 (D. Minn. 1989).

110. See *supra* notes 33-36 and accompanying text.

111. 621 S.W.2d 592 (Tex. 1981).

become operative until the mortgagee obtains possession of the property, or impounds the rents, or secures the appointment of a receiver, or takes some other similar action.¹¹²

Based upon reasoning like that in *Taylor* and other state court decisions,¹¹³ numerous bankruptcy courts concluded that an assignment of leases and rents created only an "inchoate" lien upon rents that was ineffective against third parties if the mortgagee had not taken affirmative steps prior to bankruptcy to activate that lien. As a result, these bankruptcy courts concluded that if a mortgagee had not taken action sufficient to divest the mortgagor of control over the land and its rents prior to bankruptcy – such as by obtaining the appointment of a receiver, taking possession of the land, or notifying tenants to begin paying rents directly to the mortgagee – the mortgagee's security interest in post-petition rents was "unperfected" and was thus subject to avoidance under the strong-arm clause.¹¹⁴ In such a case, the debtor was able to use post-petition rents free and clear of any claim by the mortgagee while the debtor remained in bankruptcy.¹¹⁵

112. *Id.* at 593-94 (emphasis added).

113. *See, e.g.,* *Bevins v. Peoples Bank & Trust Co.*, 671 P.2d 875, 879 (Alaska 1983), *Martinez v. Cont'l Enters.*, 730 P.2d 308, 316 (Colo. 1986); *Sullivan v. Ross-on*, 119 N.E. 405 (N.Y. 1918).

114. *See, e.g., In re Century Inv. Fund VIII L.P.*, 937 F.2d 371, 377 (7th Cir. 1991); *In re 1301 Conn. Ave. Assocs.*, 126 B.R. 1, 3 (D.D.C. 1991); *First Fed. Sav. & Loan Ass'n v. Hunter (In re Sam A. Tisci, Inc.)*, 133 B.R. 857, 859 (N.D. Ohio 1991); *Condor One, Inc. v. Turtle Creek, Ltd. (In re Turtle Creek, Ltd.)*, 194 B.R. 267, 278 (Bankr. N.D. Ala. 1996); *In re Mews Assocs., L.P.*, 144 B.R. 867, 868-69 (Bankr. W.D. Mo. 1992); *Glessner v. Union Nat'l Bank & Trust Co. (In re Glessner)*, 140 B.R. 556, 562 (Bankr. D. Kan. 1992); *Drummond v. Farm Credit Bank of Spokane (In re Kurth Ranch)*, 110 B.R. 501, 506 (Bankr. D. Mont. 1990); *In re Multi-Group III Ltd. P'ship*, 99 B.R. 5, 8 (Bankr. D. Ariz. 1989); *Armstrong v. United States (In re Neideffer)*, 96 B.R. 241, 243 (Bankr. D.N.D. 1988); *In re TM Carlton House Partners, Ltd.*, 91 B.R. 349, 355-56 (Bankr. E.D. Pa. 1988); *In re Ass'n Ctr. Ltd. P'ship*, 87 B.R. 142, 145 (Bankr. W.D. Wash. 1988); *In re Prichard Plaza Assocs. Ltd. P'ship*, 84 B.R. 289, 293-94 (Bankr. D. Mass. 1988); *In re Hamlin's Landing Joint Venture*, 77 B.R. 916, 920 (Bankr. M.D. Fla. 1987), *superceded by statute, as stated in In re 163rd St. Mini Storage, Inc.*, 113 B.R. 87, 88-89 (Bankr. S.D. Fla. 1990); *Ziegler v. First Nat'l Bank of Volga (In re Ziegler)*, 65 B.R. 285, 287 (Bankr. D.S.D. 1986); *Exch. Nat'l Bank v. Gotta (In re Gotta)*, 47 B.R. 198, 204 (Bankr. W.D. Wis. 1985).

115. A few courts took an intermediate position, relying upon a misapplication of Bankruptcy Code § 546(b). During the relevant period, Section 546(b) provided as follows:

The rights and powers of a trustee under sections 544, 545, and 549 of this title are subject to any generally applicable law that permits perfection of an interest in property to be effective against an entity that acquires rights in such property before the date of such perfection. If such law requires seizure of such property or commencement of an action to accomplish such perfection, and such property as not been seized or such action has

These disparate interpretations of state mortgage law produced substantial nonuniformity in the treatment of security interests in rents, both from state to state and even from district to district within particular states. This nonuniformity produced significant criticism among academics, real estate practitioners, and commercial mortgage lenders.¹¹⁶ This criticism prompted Congress to amend section 552(b) in 1994 in an attempt to provide more uniform treatment of assignments of rents. Prior to 1994, section 552(b) provided that a pre-petition security interest in land and rents from that land extended to post-petition rents "to the extent provided by [the] security agreement and by applicable nonbankruptcy law."¹¹⁷ By focusing upon the term "applicable nonbankruptcy law," many courts (as noted above) concluded that section 552(b) did not permit the mortgagee to claim a security interest in post-petition rents if the mortgagee had not taken sufficient steps to obtain actual or constructive possession of the land and its rents prior to bankruptcy. In 1994, Congress amended section 552(b) by removing this reference to "applicable nonbankruptcy law":

Except as provided in sections 363, 506(c), 522, 544, 547, and 548 of this title, and notwithstanding section 546(b) of this title, if the debtor and [the secured party] entered into a security agreement before the commencement of the case and if the security interest created by such security agreement extends to property of the

not been commenced before the date of the filing of the petition, such interest in such property shall be perfected by notice within the time fixed by law for such seizure or commencement.

11 U.S.C. § 546(b) (1993). Several courts concluded that even if the mortgagee had failed to take sufficient steps prior to bankruptcy to activate its assignment of rents, section 546(b) permitted the mortgagee to give the debtor post-petition notice of its intention to enforce its security interest in rents, thereby perfecting the mortgagee's security interest in post-petition rents. *See, e.g.,* Casbeer v. State Fed. Sav. & Loan Ass'n of Lubbock (*In re Casbeer*) 793 F.2d 1436, 1443 (5th Cir. 1986); Wolters Vill., Ltd. v. Vill. Props., Ltd. (*In re Vill. Props., Ltd.*), 723 F.2d 441, 444 (5th Cir. 1986); *In re Mears*, 88 B.R. 419, 421 (Bankr. S.D. Fla. 1988); McCombs Props. VI, Ltd. v. First Tex. Sav. Ass'n (*In re McCombs Props. VI, Ltd.*), 88 B.R. 261, 264 (Bankr. C.D. Cal. 1988); *In re Gelwicks*, 81 B.R. 445, 447-48 (Bankr. N.D. Ill. 1987); FDIC v. Lancaster (*In re Sampson*), 57 B.R. 304, 307 (Bankr. E.D. Tenn. 1986).

116. *See, e.g.,* Freyermuth, *The Circus Continues*, *supra* note 65, at 118; Forrester, *supra* note 82; Craig H. Averch, *Revisitation of the Fifth Circuit Opinions of Village Properties and Casbeer: Is Post-Petition "Perfection" of an Assignment of Rents Necessary to Characterize Rental Income as Cash Collateral?*, 93 COM. L.J. 516 (1988); James McCafferty, *The Assignment of Rents in the Crucible of Bankruptcy*, 94 COM. L.J. 433 (1989); Patrick A. Randolph, Jr., *Recognizing Lenders' Rents Interests in Bankruptcy*, 27 REAL PROP., PROB. & TRUST J. 281 (1992); Glenn R. Schmitt, *The Continuing Confusion Over Real Property Rents as Cash Collateral in Bankruptcy: The Need for a Consistent Interpretation*, 5 DEPAUL BUS. L.J. 1 (1992-93).

117. 11 U.S.C. § 552(b) (1978).

debtor acquired before the commencement of the case and to amounts paid as rents of such property . . . , then such security interest extends to such rents . . . acquired by the estate after the commencement of the case to the extent provided in such security agreement, except to any extent that the court, after notice and a hearing and based on the equities of the case, orders otherwise.¹¹⁸

Most commentators concluded that the amended section 552(b) established a federal standard for the enforcement of an assignment of rents, thus rendering state rent assignment law irrelevant.¹¹⁹ Unfortunately, while there is legislative history suggesting that this was Congress's intent,¹²⁰ the text itself provides no express statement of pre-emptive intent. Further, even as amended, section 552(b)'s protection for a security interest in post-petition rents is expressly subject to the trustee's strong-arm power under section 544 – *which implicitly incorporates underlying state law regarding the enforceability of a security interest against third parties*. Under section 544(a), there is no question that the debtor-in-possession may avoid a security interest in rents if a bona fide purchaser of the land could have avoided that interest under state law as of the petition date. Thus, if state law *actually provides* that a security interest in rents is ineffective against third parties until the mortgagee has taken affirmative action to enforce that security interest, section 544(a) would permit the debtor to avoid the security interest of such a mortgagee – notwithstanding section 552(b) as amended – if the mortgagee failed to take such action prior to bankruptcy.¹²¹

2. The UARA's Solution: Equating "Recording" and "Perfection."

Roughly one-third of the states have enacted statutes making clear that an assignment of rents is perfected and effective against third persons upon its recordation, without regard to whether the mortgagee has taken any steps to "activate" or "enforce" that assignment.¹²² Not all states have followed suit,

118. *Id.* § 552(b)(2).

119. *See, e.g.*, 5 COLLIER ON BANKRUPTCY ¶ 552.03[1], at 552-20 (15th ed. revised 2001) ("[Section 552(b)(2)] does not refer to applicable nonbankruptcy law and is intended to provide a creditor with a valid postpetition interest in rents notwithstanding the creditor's failure to perfect its security interest in rents under applicable state law . . .").

120. 140 CONG. REC. H10768 (daily ed. Oct. 4, 1994) (statements of Rep. Brooks).

121. Perhaps recognizing this drafting flaw, some courts faced with priority disputes regarding rents have continued to look to underlying state law "perfection" rules, notwithstanding amended section 552(b). *See, e.g.*, *In re Millette*, 186 F.3d 638 (5th Cir. 1999) (mortgagee perfected upon recording under Mississippi law).

122. CAL. CIV. CODE §§ 2938 (1993 & Supp. 2005) (amended 1996); DEL. CODE ANN. tit. 25, § 2121 (1989); FLA. STAT. ANN. § 697.07 (1994); 765 ILL. COMP. STAT. §

however. To remove any lingering question regarding the enforceability of a recorded assignment of rents, the UARA incorporates a comparable provision:

Upon recording, the security interest in rents created by an assignment of rents is fully perfected, even if a provision of the document creating the assignment or law of this state other than this [act] would preclude or defer enforcement of the security interest until the occurrence of a subsequent event, including a subsequent default of the assignor, the assignee's obtaining possession of the real property, or the appointment of a receiver.¹²³

The UARA also expressly provides that a perfected security interest in rents is entitled to priority over the rights of subsequent judicial lien creditors and persons thereafter purchasing an interest in the land or its rents.¹²⁴

C. "Absolute" Assignments of Rents

1. The Rationale for an "Absolute" Assignment of Rents and the Elevation of Form Over Substance

Southerners are familiar with kudzu, an invasive plant that rapidly spreads to cover trees and other native vegetation. The government initially advocated the planting of kudzu as an erosion control measure,¹²⁵ until it became apparent that the spread of kudzu posed a major threat to the health of

5/31.5 (2001); IND. CODE ANN. § 32-21-4-2 (2002); KAN. STAT. ANN. § 58-2343 (1994); LA. REV. STAT. ANN. § 9:4401 (1997); MD. CODE ANN., REAL PROP. § 3-204 (2003); NEB. REV. STAT. § 52-1704 (2004); N.C. GEN. STAT. § 47-20(c) (2003); OR. REV. STAT. § 93.806 (2003); S.C. CODE ANN. § 29-3-100 (1991); TENN. CODE ANN. § 66-26-116 (2004); VA. CODE ANN. § 55-220.1 (2003); WASH. REV. CODE § 7.28.230(3) (1992); WIS. STAT. § 708.11 (2001).

Both Michigan and New York have statutes addressing assignments of rents that on their face do not expressly provide that an assignment of rents is "perfected" upon recording. Nevertheless, court decisions have interpreted these statutes to establish that an assignment of rents is perfected upon recording, even without the mortgagee having taken action to enforce the assignment. MICH. COMP. LAWS ANN. §§ 554.231, 554.232 (2005), *interpreted in In re Mt. Pleasant Ltd. P'ship*, 144 B.R. 727 (Bankr. W.D. Mich. 1992); N.Y. REAL PROP. LAW § 294-a (1989), *interpreted in In re Fin. Ctr. Assocs. of E. Meadow, L.P.*, 140 B.R. 829 (Bankr. E.D.N.Y. 1992).

123. UARA § 5(b).

124. UARA § 5(c).

125. See Max Shores, *The Amazing Story of Kudzu*, <http://www.cptr.ua.edu/kudzu> (last visited Feb. 9, 2006) ("During the Great Depression of the 1930s, the Soil Conservation Service promoted kudzu for erosion control. Hundreds of young men were given work planting kudzu through the Civilian Conservation Corps. Farmers were paid as much as eight dollars an acre as incentive to plant fields of the vines in the 1940s.").

forests.¹²⁶ Until very recently, kudzu served no apparent useful purpose,¹²⁷ and is so stubborn that its eradication has proven nearly impossible.

Mortgage law has its own form of kudzu – the “absolute” assignment of rents. As American states gradually abandoned the title theory of mortgages in favor of lien theory, some mortgage lenders began drafting “absolute” assignments of rents in an effort to give mortgagees in lien theory states the ostensible benefit of title theory rules. Under the language of a typical “absolute” assignment, the mortgagor purports to transfer to the mortgagee/assignee full “title” to unaccrued rents as of the execution and delivery of the assignment. An “absolute” assignment typically will state that it is “not merely for purposes of security.” Furthermore, an “absolute” assignment will frequently state that the borrower no longer has any interest in unaccrued rents other than a revocable license (*i.e.*, that the borrower no longer has a “property” right) to collect such rents prior to the borrower’s default.¹²⁸

Whether an assignment of rents is “absolute” or instead creates a security interest in rents makes little practical difference outside of the bankruptcy context – the assignee’s ability to collect the rents is typically defined by the

126. *Id.*

127. Recently, Harvard researchers reported that experimental subjects that had taken capsules containing kudzu extract drank approximately 50% less beer in the ensuing 90 minutes than subjects that had taken a placebo, leading to speculation that kudzu might prove useful in curbing binge drinking. See Michael Kunzelman, *Study: Kudzu Helps Curb Binge Drinking*, ABC News, May 17, 2005, <http://abcnews.go.com/Health/wireStory?id=763977>.

128. A good example is the language of the assignment of rents at issue in *Home-Corp. v. Secor Bank*, 659 So. 2d 15, 18 (Ala. 1994), which provided as follows:

Mortgagor hereby assigns and transfers to Mortgagee all the rents, issues and profits of the Mortgaged Property, and Hereby gives to and confers upon the Mortgagee the right, power and authority to collect such rents, issues and profits. Mortgagor irrevocably appoints Mortgagee its true and lawful attorney-in-fact at the option of Mortgagee at any time and from time to time, to demand, receive and enforce payment, to give receipts, releases and satisfactions, and to sue, in the name of the Mortgagor or Mortgagee, for any such rents, issues and profits and provided, however, that Mortgagor shall have the right to collect such rents, issues and profits (but not more than two months in advance) prior to or at any time there is not notice of an event of default under this Mortgage, the Note, the Loan Agreement and a guaranty of such documents and any other instruments given as evidence to further secure the payment and performance of any obligation secured by this Mortgage (which documents collectively are sometimes hereinafter referred to as “Loan Instruments”). The assignment of the rents, issues and profits of the Mortgaged Property in this Article II is intended to be an absolute assignment from the Mortgagor to the Mortgagee and not merely the passing of a security interest. The rents, issues and profits are hereby assigned absolutely by Mortgagor to Mortgagee contingent only upon the occurrence of an uncured event of default under any of the Loan Instruments.

terms of the assignment, and in any event the assignee must apply any collected rents to the mortgage debt. However, a mortgage lender's primary objective in taking an "absolute" assignment of rents is to attempt to improve its position in the event of the mortgagor's bankruptcy. When a debtor files for bankruptcy, all of the property in which the debtor holds an interest becomes property of the bankruptcy estate.¹²⁹ The debtor generally may use property of the estate in the course of its bankruptcy proceeding, subject to the obligation to provide adequate protection to a secured creditor holding a lien upon that property (assuming that secured creditor requests adequate protection of its lien).¹³⁰ Moreover, a secured party holding a security interest in property of the estate is subject to the automatic stay and cannot seek to enforce its lien or otherwise collect the debt outside the context of the bankruptcy proceeding.¹³¹ A debtor that owns commercial land thus has a substantial incentive to argue that post-petition rents generated by the land constitute property of the estate. By contrast, the mortgagee/assignee would prefer that the law characterize the rents as property that is *not* part of the estate. If the land's post-petition rents are not property of the estate, the automatic stay would place no limit upon the mortgagee's ability to collect those rents and apply them to the debt.¹³²

Obviously, if a mortgagee has already completed a foreclosure sale prior to the debtor's bankruptcy filing, then the land and unaccrued rents would belong to the foreclosure purchaser and would no longer constitute property of the bankruptcy estate. But if the mortgagee has not yet completed a foreclosure sale – and thus equitable ownership of the land remains in the debtor – unaccrued post-petition rents fit squarely within the Code's broad concept of "property of the estate." Mortgage lenders have frequently argued, however, that if a mortgagor executed an "absolute" assignment of rents, then title to the unaccrued post-petition rents has passed to the lender and those rents thus do not constitute property of the bankruptcy estate. Adopting the lenders' argument would permit the mortgagee to collect post-petition rents from the land without regard to the automatic stay, and would thus substantially increase the mortgagee's practical leverage over the debtor. A significant number of bankruptcy court decisions have validated this practice, holding that where a bankrupt mortgagor

129. 11 U.S.C. § 541(a) (2000).

130. 11 U.S.C. § 363(b) (2000 & Supp. 2005).

131. *Id.* § 362(a).

132. Such a characterization would be particularly important in a case where a mortgage loan is undersecured (*i.e.*, where the unpaid balance of the mortgage debt exceeds the value of the land), because of the *Timbers* case, in which the Supreme Court held that an undersecured creditor is not entitled to collect interest upon the debt during the pendency of the bankruptcy case. *United Sav. Ass'n of Tex. v. Timbers of Inwood Forest*, 484 U.S. 365 (1988). If post-petition rents do not constitute property of the estate, then the undersecured lender could collect net post-petition rentals and apply them to reduce the unsecured portion of its claim on a dollar-for-dollar basis, thereby improving its total recovery vis-a-vis the debtor's other unsecured creditors.

had executed an "absolute" assignment of rents prior to bankruptcy, post-petition rents do not constitute property of the estate.¹³³

The extent to which the rhetoric associated with "absolute" assignments of rents can poison decisionmaking is most vividly demonstrated by a trilogy of Third Circuit decisions. The first is the 1993 decision in *Commerce Bank v. Mountain View Village, Inc.*¹³⁴ In *Mountain View*, when the owner of an apartment complex defaulted on its mortgages, the mortgagees began collecting rents directly from tenants by notifying the tenants to pay the mortgagees. Subsequently, the mortgagor filed for bankruptcy and sought to use the post-petition rentals generated by the complex in its reorganization plan. The mortgagees objected that the rents did not constitute property of the estate because the mortgagees had already enforced their respective interests in the rents by collection prior to the mortgagor's bankruptcy. The bankruptcy court ruled that the mortgagor retained an equitable interest in the rents and that this equitable interest was property of the bankruptcy estate. The district court reversed this ruling, and the Third Circuit affirmed, concluding that the mortgagor retained no equitable interest in the post-petition rents. In reaching this conclusion, the Third Circuit relied upon its interpretation of Pennsylvania law, based upon Pennsylvania's adherence to the title theory of mortgages:

The stipulated facts conclusively establish that the banks are the holders of mortgages that contain assignments of rents conditioned upon default, that the debtor did default, and that, after notifying the tenants, the banks collected the rents. Under Pennsylvania law, it is clear that the banks were legally entitled to take the steps they did when the debtor was unable to cure the default. Therefore, the rents are not property of the debtor's estate and are not available for use in a plan of reorganization. . . .

133. *First Fid. Bank v. Jason Realty, L.P. (In re Jason Realty, L.P.)*, 59 F.3d 423 (3d Cir.1995); *Robin Assocs. v. Metro. Bank & Trust Co. (In re Robin Assocs.)*, 275 B.R. 218 (Bankr. W.D. Pa. 2001); *In re Kingsport Ventures, L.P.*, 251 B.R. 841 (Bankr. E.D. Tenn. 2000); *In re Carretta*, 220 B.R. 203 (Bankr. D.N.J. 1998); *Condor One, Inc. v. Turtle Creek, Ltd. (In re Turtle Creek)*, 194 B.R. 267 (Bankr. N.D. Ala. 1996); D.N.J. 1995); *First Fid. Bank v. Eleven Hundred Metroplex Assocs.*, 190 B.R. 510 (Bankr. S.D.N.Y. 1995); *MacArthur Executive Assocs. v. State Farm Ins. Co.*, 190 B.R. 189 (Bankr. D. N.J. 1995); *In re Carter*, 126 B.R. 811 (Bankr. M.D. Fla. 1991); *In re Galvin*, 120 B.R. 767 (Bankr. D. Vt. 1990); *In re Gould*, 78 B.R. 590 (Bankr. D. Idaho 1987); *In re Fry Rd. Assocs.*, 64 B.R. 808 (Bankr. W.D. Tex. 1986); *In re P.M.G. Props.*, 55 B.R. 864 (Bankr. E.D. Mich. 1985). See also *NCNB Tex. Nat'l Bank v. Sterling Projects, Inc.*, 789 S.W.2d 358 (Tex. App. 1990) ("The absolute assignment does not create a security interest but instead passes title to the rents. An absolute assignment of rents is not security but is a *pro tanto* payment of the obligation."); 801 *Nolana, Inc. v. RTC Mortgage Trust 1994-S6*, 944 S.W.2d 751 (Tex. App. 1997) (same).

134. 5 F.3d 34 (3rd Cir. 1993).

In the case here, the district court held that the banks would prevail even if the mortgages were considered to be security interests rather than transfers of title. We need not determine that issue because the facts and prevailing Pennsylvania law establish that the banks had the right to enter the property, constructively as well as actually, and to collect the rents. We find no indication that Pennsylvania has veered from its longstanding title theory to one treating mortgages as security interests.¹³⁵

This passage reflects a rather shocking misapprehension of what the title theory of mortgages actually means. There's a good reason that it's called the title theory of *mortgages* – it's a theory of *mortgage law*. The conveyance of title may be a conveyance of title, *but for the purpose of securing a debt*. Thus, when the mortgagees collected the pre-petition rents and applied them to the debt consistent with the terms of the loan documents, the mortgagees were acting consistent with mortgage law. Once the rents were “collected” and applied to reduce the debt, this extinguished the mortgagor's interest in those collected rents. But the *Mountain View* court wrongly applied the same reasoning to the post-petition rents, which had neither accrued nor been collected by the mortgagee as of the petition date. Properly viewed, the mortgagor's interest in those rents was not extinguished – even under the title theory – simply because the mortgagees held “title” to the rents. This title was still held only to secure the mortgage debt. Had the mortgagor paid off the mortgage debt, the mortgagee's “title” in not-yet-accrued rents would have been extinguished along with the mortgagee's “title” to the mortgaged land.

Nevertheless, two years later, in *In re Jason Realty, L.P.*,¹³⁶ the Third Circuit faced a similar factual dispute – and made a similar analytical mistake – regarding a New Jersey office building. Although New Jersey follows the lien theory, the Third Circuit concluded that the lien theory/title theory distinction made no difference, because the mortgage documentation included an absolute assignment of rents that had effected a transfer of “title” to the rents:

An absolute assignment transfers title to the assignee upon its execution. An assignment is absolute if its language demonstrates an intent to transfer immediately the assignor's rights and title to the rents. The instant assignment was quintessentially absolute, because it was a total assignment in *per verba de praesenti*: Jason Realty “hereby grants, transfers and assigns to the assignee the entire lessor's interest in and to those certain leases . . . Together with all rents.” These parties mutually agreed in words of the present to

135. *Id.* at 38-39 (citations omitted).

136. 59 F.3d 423 (3rd Cir. 1995).

transfer full title to the rents. This exchange inescapably and unambiguously expressed an agreement to assign present title.¹³⁷

Again, the court's ruling is an astonishing misconstruction of mortgage law. Essentially, the court concluded that an assignment of rents executed in conjunction with a mortgage transaction effected a *true sale* of rents arising from the mortgaged property, simply because the parties called it an "absolute assignment." Yet the assignment was not a true sale, as evidenced by the fact (among many others) that the terms of the assignment required the application of the rents to the mortgage debt. Just because a mortgagee in a lien theory state tries to contract itself into the position it would enjoy in a title theory state does not make the transaction any less a mortgage transaction.

Finally, just this past July, the Third Circuit decided *Sovereign Bank v. Schwab*,¹³⁸ which involved three commercial rental properties in Pennsylvania subject to a mortgage held by Sovereign Bank. Apparently, following the mortgagor's default, Sovereign Bank first notified tenants to begin paying rents to it. Shortly thereafter, Sovereign Bank was appointed as a receiver for the properties. For approximately four months, Sovereign Bank collected rents as a receiver, until the county sheriff conducted a foreclosure sale at which "the mortgaged properties were sold to [Sovereign Bank] for cost."¹³⁹ Shortly after the foreclosure, the mortgagor filed for bankruptcy and the bankruptcy trustee sued Sovereign Bank for turnover of the rents it had collected as a receiver. [Regrettably, the facts do not indicate how much Sovereign Bank had collected in rentals, and whether it had actually applied those rentals against the mortgage debt or whether it was still holding the accumulated rents.] The bankruptcy court ruled in favor of the trustee, and the district court affirmed. The Third Circuit reversed, however, holding that under *Mountain View*, Sovereign Bank held "title" to the rents and that the rents it had collected were not property of the estate subject to turnover.¹⁴⁰

Schwab is either an unexceptional case or a gross misapplication of mortgage law. Unfortunately, the court's incomplete statement of the facts makes it impossible to say which. The problem is the court's cryptic statement that Sovereign Bank purchased the mortgaged properties at foreclosure "at cost." Benignly, this could mean that Sovereign Bank purchased the mortgaged premises for an amount equal to its appraised value but less than the mortgage debt – in which case Sovereign Bank would have been undersecured, and properly could have (and perhaps did) apply the collected rents to this deficiency amount. Equally benignly, Sovereign Bank might have applied all of the collected rents to reduce the mortgage debt prior to foreclosure, and then might have made a full credit bid (thereby extinguishing the

137. *Id.* at 427 (citations omitted).

138. 414 F.3d 450 (3rd Cir. 2005).

139. *Id.* at 452.

140. *Id.* at 453.

debt). Both of these results are fully consistent with a correct application of mortgage law. However, the court's cryptic language leaves open the possibility that Sovereign Bank made a full credit bid at the same time that it was also holding a pool of rents that it had collected as a receiver but had not yet applied to the debt. If those are the facts, then Sovereign Bank's full credit bid should have extinguished the mortgage debt and Sovereign Bank's "title" to the pool of collected rents – even under the title theory, the mortgagee's "title" still only secures the mortgage debt. Under that scenario, the proper decision would have been that the collected rents still belonged to the mortgagor and became property of the bankruptcy estate.

2. The UARA and the Elevation of Substance Over Form

Most commentators have rejected the "absolute" assignment of rents (and the "analysis" reflected in the Third Circuit's case law) as pure form over substance – and properly so, given the context of the typical commercial mortgage transaction.¹⁴¹ The typical "absolute" assignment of rents is only a security device, as is evident from the circumstances surrounding the typical "absolute" assignment. These circumstances include the facts that (a) the assignment is executed contemporaneously with a mortgage, (b) the mortgagor may collect and dispose of rents prior to default, (c) the assignee typically may not collect rents prior to default, even though the assignment might nominally characterize such rents as the assignee's "property," and (d) the assignment requires that any rents collected by the assignee be applied to the mortgage indebtedness. These circumstances demonstrate clearly that the parties intend for the assignment of rents to secure the mortgagor's obligation to repay the mortgage debt – the "absolute" assignment is merely a security device despite its "absolute" label.

Mortgage law has long established that instruments purporting to convey absolute title to land nevertheless create only equitable liens if the circumstances demonstrate that the parties are using title to land to secure payment of a debt.¹⁴² Under this same principle, a court should re-characterize the typical "absolute" assignment of rents as an assignment for security

141. See, e.g., RESTATEMENT (THIRD) OF PROP.: MORTGAGES § 4.2 Reporters' Note (1997) ("The use of 'absolute assignment' terminology . . . creates needless confusion and is rejected . . .").

142. See, e.g., *id.* § 3.2 (absolute deed intended to secure an obligation constitutes a mortgage); *Smith v. Player*, 601 So. 2d 946 (Ala. 1992) (same); *Steckelberg v. Randolph*, 404 N.W.2d 144 (Iowa 1987) (same). This is likewise consistent with U.C.C. Article 9, under which (generally speaking) any transaction that creates an interest in personal property to secure payment or performance of an obligation constitutes a security transaction (and not an outright transfer), regardless of its form. U.C.C. §§ 1-201(b)(35), 9-109(a)(1).

purposes, and the weight of modern judicial authority so provides.¹⁴³ Under this view, where the mortgagee has not taken sufficient steps to enforce its security interest prior to bankruptcy, post-petition rents would constitute property of the bankruptcy estate.

Consistent with this approach, the UARA rejects the notion that an assignment of rents executed in the context of a mortgage transaction constitutes an “absolute” assignment. The UARA defines an “assignment of rents” as “a transfer of an interest in rents in connection with an obligation secured by real property located in this state and from which the rents arise.”¹⁴⁴ The UARA further provides that any assignment of rents creates only a security interest in rents, regardless of whether the agreement is in the form of an absolute assignment.¹⁴⁵

143. *In re 5877 Poplar, L.P.*, 268 B.R. 140 (Bankr. W.D. Tenn. 2001); *Carvos v. Fleet Nat'l Bank (In re Cavros)*, 262 B.R. 206 (Bankr. D. Conn. 2001); *In re Guardian Realty Group, L.L.C.*, 205 B.R. 1 (Bankr. D.D.C. 1997); *CS First Boston Mortgage Capital Corp. v. RV Centennial P'ship (In re RV Centennial P'ship)*, 202 B.R. 774 (Bankr. D. Colo. 1996); *Lyons v. Fed. Sav. Bank (In re Lyons)*, 193 B.R. 637, 644 (Bankr. D. Mass. 1996); *Nat'l Operating, L.P. v. Mut. Life Ins. Co. of New York*, 630 N.W.2d 116 (Wis. 2001).

144. UARA § 2(2). This definition would not encompass an assignment of rents that was made outside the context of a mortgage transaction. However, assignment of rents that are intended as security inevitably are made in the context of a mortgage transaction.

Technically, there is no legal barrier to prevent a landlord from making a true sale of rents (in the same sense that a seller of goods on credit or a provider of services can make a true sale of accounts receivable). One could view the transfer by sale of a fee simple absolute as an effective “true sale” of future rents. The UARA drafting committee received one anecdotal report from a lawyer who reported that his landlord client regularly “factored” his rents. If a landlord executed a document that purported to be (and in substance was) an outright sale of rents, and this document was not executed in the context of a mortgage transaction, the document would not effect an “assignment of rents” within the meaning of UARA, and UARA would not apply to it. By contrast, if a landlord executed a document that purported to be an outright sale of rents, but did so in the context of a mortgage transaction, the document would effect an “assignment of rents” under UARA and would create only a security interest in the rents. With respect to the rights of the assignee versus conflicting interests, this result is consistent with the treatment of accounts receivable under Article 9. *See* U.C.C. § 1-201(b)(35) (2001) (“security interest” includes “any interest of a . . . buyer of accounts, chattel paper, a payment intangible, or a promissory note in a transaction that is subject to Article 9”); *id.* § 9-109(a)(3) (Article 9 “applies to . . . a sale of accounts, chattel paper, payment intangibles, or promissory notes”); § 9-318(b) (deemed security interest created by sale of accounts must be perfected to make it effective as against creditors of the seller).

145. UARA § 4(b) (“An assignment of rents creates a presently effective security interest in all accrued and unaccrued rents arising from the real property described in the document creating the assignment, regardless of whether the document is in the form of an absolute assignment, an absolute assignment conditioned upon default, an assignment as additional security, or any other form.”).

D. Rents Accruing Prior to Foreclosure: "Separate" Collateral, or "Subsumed Within the Land"?

As discussed earlier, most disputes regarding security interests in rents are resolved in bankruptcy proceedings, with the debtor and the mortgagee fighting to control post-petition rents. In a series of cases during the 1990s, several bankruptcy decisions explored whether a mortgagee's interest in post-petition rents constituted "separate" collateral or was instead "subsumed" within the land.¹⁴⁶ To see why this distinction might matter, one must appreciate the Bankruptcy Code's provisions regarding the debtor's ability to use encumbered property of the estate.

If a creditor has an unavoidable security interest in collateral, the Code ostensibly prevents the debtor from using the collateral over the creditor's objection, unless the debtor can provide the creditor with "adequate protection" of its interest in the collateral¹⁴⁷ or (in the case of rents or proceeds of collateral) unless the court concludes that the "equities of the case" otherwise justify the debtor's use.¹⁴⁸ As a result, when the owner of a commercial land development seeks bankruptcy protection, the mortgagee (assuming it holds an assignment of rents) typically files an immediate motion seeking to prohibit the debtor's use of rents or to sequester the rents in a separate account outside the debtor's control. The mortgagee's position is that the assignment of rents creates a security interest in the rents in addition to the mortgage lien on the underlying land – and thus that the debtor should have to provide adequate protection of the mortgagee's interest in rents *in addition to* adequate protection of the mortgagee's interest in the land. By contrast, the debtor/mortgagor may argue that because the rents arise from the land, the debtor should be able to use the rents for its own purposes as long as it can provide adequate protection of the mortgagee's interest in the land.

The proper resolution of this issue has profound consequences for the parties to the commercial mortgage. This is especially true for an undersecured mortgagee (where the value of the mortgaged premises is less than the mortgage debt). If the rents and the land are distinct sources of collateral, then the mortgagee's total secured position (the value of the land plus accrued post-petition rents) would increase during the pendency of the bankruptcy

146. For a detailed discussion of these cases, see Freyermuth, *The Circus Continues*, *supra* note 65.

147. For noncash collateral, a secured creditor must file a motion with the bankruptcy court seeking adequate protection of its interest in order to condition or prohibit the debtor's use of the collateral. 11 U.S.C. § 363(c)(1), 363(e) (2000). For cash collateral (including rents), the burden shifts to the debtor to obtain either the secured party's consent or the bankruptcy court's approval for such use in advance. *Id.* § 363(c)(2).

148. Under Bankruptcy Code § 552(b)(2), the bankruptcy court retains the authority to limit a lender's security interest in post-petition rents, after notice and a hearing, based upon the "equities of the case." *Id.* § 552(b)(2).

case as post-petition rents accrue. Over time, this accrual could reduce – and perhaps even eliminate – the undersecured portion of the mortgagee’s claim. This view, of course, has profoundly negative consequences for the debtor/mortgagor. First, it would effectively increase the amount that the debtor must devote to satisfying the mortgagee’s claim under its Chapter 11 plan.¹⁴⁹ Second, if post-petition rents are distinct from the land, the Code’s adequate protection standards would make it difficult for the debtor to use accrued post-petition rents to fund its reorganization efforts and expenses.¹⁵⁰

In an attempt to retain greater control over post-petition rents, numerous mortgagors advanced the theory that adequate protection of a mortgagee’s interest in rents is unnecessary because rents are “subsumed” in the land. This hypothesis was based upon the assumption that the value of land at a particular point in time already reflects – indeed, is a mathematical function of – the value of net rentals that will accrue in the future. To the extent that a mortgagee’s secured claim is measured by the value of the land on the petition date,¹⁵¹ that value already “subsumes” all post-petition rentals. As a result, the hypothesis goes, it is inappropriate to treat post-petition rents as collateral that is distinct from the land itself. Under this approach, the mortgagee’s security interest in the land (and its future rents) remains “adequately protected” so

149. Because the *Timbers* decision, *United Sav. Ass’n of Tex. v. Timbers of Inwood Forest*, 484 U.S. 365 (1988), mandates that an undersecured creditor may not collect pendency interest on the secured portion of its claim, the total size of the mortgagee’s total claim would not change during the bankruptcy case. Nevertheless, the secured and unsecured proportions of that claim would change – the secured portion would increase and the unsecured portion would decrease – as net post-petition rents accrued. Once the debtor gains confirmation of its Chapter 11 plan, the debtor/mortgagor must effectively pay 100% of the mortgagee’s secured claim – and with interest, if the debtor does not pay the claim in cash at confirmation. In the typical Chapter 11 plan, however, the debtor/mortgagor does not pay 100% of the mortgagee’s unsecured claim, and further does not pay interest on unsecured claims. As a result, to the extent that the accrual of post-petition rents increases the mortgagee’s secured claim, it also effectively increases the total resources that the debtor must devote to repayment of the mortgagee’s claims.

150. 11 U.S.C. § 363(c)(2), 363(e) (2000) (debtor cannot use cash collateral without consent of secured party or court approval; court must prohibit/condition use of cash collateral as necessary in order to adequately protect secured party’s interest). Section 361 provides that adequate protection can take the form of cash payments, a replacement lien upon other collateral (to compensate for the depreciation/exhaustion of the collateral being used), or any other form of relief that provides the creditor with the “indubitable equivalent” of its interest in the collateral. *Id.* § 361. If the secured creditor’s claim is oversecured (*i.e.*, if the value of the land exceeds the balance of the debt), then this equity cushion may provide adequate protection for the use of post-petition rents. See DAVID G. EPSTEIN, STEVE H. NICKLES & JAMES J. WHITE, *BANKRUPTCY* § 3-27, at 147 (1993). In many cases, however – particularly single-asset real estate cases where the debtor has no source of cash flow other than project rents – the adequate protection standard will be insurmountable where the mortgage is undersecured.

151. *Timbers*, 484 U.S. 365.

long as the land itself is not declining in value – even if the debtor/mortgagor consumes all of the rents that accrue during the pendency of the bankruptcy case. As a result, mortgagors have argued that because the mortgagee bears the burden of proving that it lacks adequate protection, bankruptcy courts should presumptively allow a debtor/mortgagor to use post-petition rents without regard to the mortgagee's assignment of rents, absent sufficient proof that the mortgaged land is declining in value.

A number of bankruptcy courts adopted this view to justify disencumbering post-petition rents. The most representative decision was *In re Mullen*.¹⁵² The debtor in *Mullen* owned several parcels of land (with an aggregate value of \$2.84 million) subject to mortgages and assignments of rents in favor of BayBank, securing a total debt of \$3.5 million. Following the debtor's petition, BayBank sought relief from the automatic stay to foreclose the mortgages; sought adequate protection of its security interest in the rents; and moved for an order requiring the debtor to turn over or segregate net rentals. The bankruptcy court denied BayBank's motion, concluding that because the value of the parcels themselves was not declining, BayBank's security interest in the rents was by definition adequately protected – even if the debtor consumed a month's worth of net post-petition rents without a corresponding reduction in the mortgage debt. The court explained:

BayBank says the value of its interest in the Debtor's property declines each time the Debtor consumes a month's rent in its operations. That is not so. Although BayBank loses its security interest in each month's rents as the rents are consumed, BayBank retains its security interest in all future rents. The value of that stream of future rents is not declining. The lien on each month's rents replaces the lien on the prior month's rents, so there is a replacement lien of equal value, within the meaning of section 361.¹⁵³

To bolster its conclusion, the *Mullen* court drew an analogy between rents and the proceeds of receivables and inventory. The court argued that as contrasted with other cash collateral like a certificate of deposit – which would not be automatically replaced if consumed by the debtor – “[r]ents and receivable proceeds . . . constantly renew themselves.”¹⁵⁴ *Mullen* thus concluded that “[s]o long as the debtor is not operating at a loss, or rents are not declining, the renewals provide constant value” and that BayBank's security interest was thus adequately protected.¹⁵⁵ To the *Mullen* court, the conclusion that “rents are subsumed in the land” followed logically from the premises implicit in valuation of commercial real estate:

152. 172 B.R. 473 (Bankr. D. Mass. 1994).

153. *Id.* at 476.

154. *Id.* at 478.

155. *Id.* at 478, 481.

The value of the Debtor's properties is . . . based upon their rental incomes. As a result, so too is the value of BayBank's mortgage interest. It is thus impossible to arrive at a value of BayBank's interest in rents which is independent of the value of its mortgage interest. The value of that mortgage interest is not declining because rents are not declining. Consumption of those rents in the Debtor's real estate operations has no adverse effect upon the mortgage value.¹⁵⁶

The decision in *Mullen* (and other court decisions adopting the "rents are subsumed within the land" hypothesis) was correct to suggest that an income-approach valuation of commercial real estate implicitly "subsumes" unaccrued rents. However, this observation does not justify a conclusion that a *security interest* in rents is wholly "subsumed" within an adequately protected mortgage lien.

It is true that a foreclosure sale purchaser – who has no claim against rents already accrued and collected prior to sale – would establish its bid based upon the expected stream of unaccrued rents. But the very purpose of the assignment of rents is to provide the lender with a claim against rents that accrue prior to foreclosure (or, in the bankruptcy context, during the pendency of the bankruptcy proceeding while the mortgagee remains subject to the automatic stay). As other courts have correctly recognized, these accumulated revenues would *not* be factored into a valuation of the land.¹⁵⁷ Second, the *Mullen* court's conclusion fails to take account of the impact of the notorious *Timbers* decision, which held that the debtor's obligation to provide "adequate protection" of a secured creditor's mortgage did not obligate the debtor to pay interest on the debt during the pendency of the bankruptcy case. To the extent that *Timbers* creates a "gap" between the value of the claim

156. *Id.* at 478.

157. As Judge Leif Clark has observed:

The way appraisers value real property further supports [the observation that an assignment of rents confers rights that have discrete value apart from the mortgage]. . . . [There are] three general approaches appraisers use to value real property (income, comparable sales, and replacement cost). No one approach by itself yields the true value of the property. Income-producing property is not merely worth the present value of a net income stream. Current real estate market conditions and the cost of construction also must be taken into account. . . .

What appraisers are valuing (or predicting) is what someone would be willing to pay to *own* the property and enjoy its fruits. The income approach measures the *ability* of the property to produce a return on investment (via an income stream) that would justify a buyer's paying the indicated market value to own the property. The right to specific rents *prior* to ownership of the property, conferred by an assignment of rents, is *a priori* not calculated into this value.

In re Landing Assocs., Ltd., 122 B.R. 288, 296-97 (Bankr. W.D. Tex. 1990).

evidenced by the mortgage debt and the value of the mortgaged premises,¹⁵⁸ an assignment of rents effectively helps to close that gap by providing the mortgagee with recourse to rents that accrue during the pendency of bankruptcy, while the mortgagee remains subject to the automatic stay. Finally, the *Mullen* court's rationale fails to account for the fact that rents from commercial real estate projects do not "constantly renew themselves" automatically. A commercial real estate development is a capital asset with a limited economic life. As a project ages, functional and economic obsolescence diminish its revenue-generating capacity, and it will not continue to generate returns consistent with historical expectations (*i.e.*, rents that "constantly renew themselves") absent a new capital investment to infuse the project with a new productive capacity. In this regard, some portion of project rents reflects

158. The impact of *Timbers* compromises the *Mullen* court's observation that the value of BayBank's mortgages followed inexorably from the value of the projects' rental streams. Because BayBank's mortgages were undersecured – and because BayBank accordingly could not collect interest on the debt during the pendency of bankruptcy – one would have to discount the value of BayBank's mortgages (*i.e.*, discount it from the fair market value of the mortgaged parcels) in order to account for the expected time period during which the debtor would remain in bankruptcy (and during which the purchaser would not be collecting interest on the debt). In other words, a buyer purchasing BayBank's mortgages would pay less to acquire those mortgages than it would have paid to acquire the mortgaged parcels themselves (and the future rent streams). For an undersecured mortgagee in bankruptcy – thanks to *Timbers* – the economic value of its claim based upon the mortgage debt must of necessity be less than the economic value of the mortgaged parcel.

As a result, an assignment of rents plainly offers a source of collateral that is separate and distinct from that offered by the mortgage itself. The very purpose of the assignment of rents is to provide the mortgagee/assignee with security in rents accruing prior to the mortgagee's foreclosure (and potential acquisition of project ownership). To the extent that *Timbers* creates a "gap" between the value of the claim evidenced by the mortgage debt and the value of the mortgaged premises, an assignment of rents effectively helps to close that gap by providing the mortgagee with recourse to rents that accrue during the pendency of bankruptcy (while the mortgagee remains subject to the automatic stay).

A few courts have wrongly concluded that *Timbers* established a general principle that a secured creditor's secured position could not improve during the pendency of the bankruptcy, and have thus held that a court should exclude postpetition rents from the valuation of the mortgagee's secured claim. *See, e.g., In re Embassy Props. N. Ltd. P'ship*, 196 B.R. 172 (Bankr. D. Kan. 1996); *In re Kalian*, 169 B.R. 503 (Bankr. D.R.I. 1994); *In re Reddington/Sunarrow Ltd.*, 119 B.R. 809 (Bankr. D.N.M. 1990). The sounder view is that post-petition rents properly increase the undersecured mortgagee's overall secured position during the pendency of the bankruptcy case. *See, e.g., Beal Bank, S.S.B. v. Waters Edge Ltd. P'ship*, 248 B.R. 668 (Bankr. D. Mass. 2000); *Homestead Partners, Ltd. v. Condor One, Inc. (In re Homestead Partners, Ltd.)*, 200 B.R. 274 (Bankr. N.D. Ga. 1996); *In re Union Meeting Partners*, 178 B.R. 664 (Bankr. E.D. Pa. 1995); *In re Columbia Office Assocs.*, 175 B.R. 199 (Bankr. D. Md. 1994); *In re Landing Assocs., Ltd.*, 122 B.R. at 296-97.

the proceeds of the exhaustion of the development's productive capacity over time.¹⁵⁹

To the extent that *Mullen* and comparable bankruptcy decisions could be read to rely upon state law to support the "rents are subsumed within the land" hypothesis, the UARA rejects those decisions and establishes that a security interest in rents is "separate and distinct" from any mortgage lien upon the land from which the rents arise.¹⁶⁰ By rejecting the "rents are subsumed within the land" hypothesis, the UARA should increase the likelihood that the mortgagee's interest in rents will be accorded the appropriate protection in bankruptcy.

It is worth noting, however, that a state's adoption of the UARA does not necessarily mean that a bankrupt mortgagor would be unable to use post-petition rentals if it could not provide adequate protection of the mortgagee's security interest in collected post-petition rentals. The Bankruptcy Code permits the court to allow the debtor to use post-petition rentals as appropriate "based on the equities of the case."¹⁶¹ As I have suggested previously, this section should permit a court to allow the debtor to use post-petition rentals to pay post-petition expenses of operating the real property – thus facilitating the debtor's operations in bankruptcy and the debtor's ability to attempt to reorganize its financial affairs – so long as the debtor's expenditures also include an appropriate capital reserve to account for the fact that the debtor's post-petition use exhausts some portion of the property's economic useful life.¹⁶²

III. THE UARA AND THE COLLECTION OF RENTS

When an assignee of rents attempts to enforce its security interest in rents or actually collects rents, a number of issues can arise in addition to the issues described in Part II. These issues include (a) what evidentiary showing an assignee must make in order to obtain the appointment of a receiver to collect rents;¹⁶³ (b) the mortgagor's liability for "milking" rents (*i.e.*, collecting rents after default without directing them to the payment of the mortgage debt);¹⁶⁴ (c) what rights the assignee may have to collect rents via direct notification to tenants (and whether a tenant that pays the assignor faces the risk of double liability);¹⁶⁵ (d) whether a mortgagee that collects rents has any legal duty to apply those rents to the payment of taxes and other property-

159. See *supra* notes 65-67 and accompanying text.

160. UARA § 4(b).

161. 11 U.S.C. § 552(b)(2) (2000).

162. See Freyermuth, *The Circus Continues*, *supra* note 65, at 128-33.

163. See *infra* notes 171-190 and accompanying text.

164. See *infra* notes 191-200 and accompanying text.

165. See *infra* notes 201-212 and accompanying text.

related expenses;¹⁶⁶ (e) priority among competing assignments of rents;¹⁶⁷ (f) priority between an assignee of rents and a person holding an Article 9 security interest in money or other personal property that also constitutes proceeds of rents covered by the UARA;¹⁶⁸ (g) whether the assignee's collection of rents renders the assignee a "mortgagee in possession";¹⁶⁹ and (h) the effect of the mortgagee's collection of rents upon the mortgagee's ability to enforce the mortgage debt.¹⁷⁰ Part III discusses prevailing law with respect to each of these issues, and highlights the manner in which the UARA would resolve each.

A. Standards for the Appointment of a Receiver.

In many states, mortgagees often seek to enforce an assignment of rents by petitioning the court to appoint a receiver for the mortgaged real property pending foreclosure. There are several reasons why receivership has often been a preferred means of enforcing an assignment of rents. First, as discussed in Part IIB, many courts have concluded that obtaining a receiver was one of the only steps by which a mortgagee could unmistakably perfect or activate its assignment of rents.¹⁷¹ Second, by obtaining a receiver, a mortgagee can enforce its assignment of rents without incurring the potential liabilities associated with becoming a "mortgagee in possession."¹⁷² Third, because appointment of a receiver typically requires a court order, any uncertainties over the operation of the mortgaged premises can be resolved either by reference to state law authorizing the appointment of a receiver or to the court order appointing that receiver.

Unfortunately, while courts in all states have the unquestioned equitable discretion to appoint a receiver, few states have statutes that establish individual or comprehensive standards to guide a court's exercise of that discretion. In states without such statutes, there is a great deal of variation in court opinions regarding the circumstances under which appointment of a receiver

166. See *infra* notes 213-223 and accompanying text.

167. See *infra* notes 224-232 and accompanying text.

168. See *infra* notes 233-245 and accompanying text.

169. See *infra* notes 246-250 and accompanying text.

170. See *infra* notes 251-255 and accompanying text.

171. See *supra* notes 105-121 and accompanying text. As discussed in Part IIB, the enactment of UARA would clarify that recording of an assignment of rents would be sufficient to perfect that interest in rents.

172. This responsibility includes potential personal liability in tort for injuries resulting from the mortgagee's operation of the land and by reason of the mortgagee's failure to perform duties imposed by law upon landowners. See, e.g., NELSON & WHITMAN, *supra* note 6, § 4.26, at 228. This responsibility also includes a strict duty to account to the mortgagor for rents collected from the land and a duty to use reasonable efforts to preserve and maintain the land so as to avoid injury or diminution of its value. *Id.* § 4.28, at 232; *id.* § 4.29, at 234.

is appropriate. For example, some court decisions have concluded that a mortgagee cannot obtain the appointment of a receiver if the mortgagee's security is adequate (*i.e.*, if the value of the mortgaged land exceeds the debt) and/or the land is not subject to existing or threatened waste.¹⁷³ Other court decisions go even further and require a showing that the mortgagor is insolvent.¹⁷⁴ The experience of practicing commercial real estate attorneys reported to the UARA's drafting committee also reflects this variation. Attorneys in some states reported that they routinely obtain the appointment of a receiver after the mortgagor's default, without demonstrating more than the existence of a default and the presence of a clause in the mortgage by which the mortgagor consented to the appointment of a receiver following default. By contrast, attorneys in other states reported that courts would not appoint a receiver without substantial documentary evidence of waste by the mortgagor (*i.e.*, physical destruction or deterioration of the mortgaged premises).

Even in states that have adopted some statutory guidelines, there remains significant state-to-state variation. Some statutes require a showing that the land is threatened with waste or comparable injury¹⁷⁵ and/or that the land's value does not provide sufficient security for the debt.¹⁷⁶ Other stat-

173. *See, e.g.*, *Dart v. W. Sav. & Loan Ass'n*, 438 P.2d 407 (Ariz. 1968); *Atco Constr. & Dev. Corp. v. Beneficial Sav. Bank*, F.S.B., 523 So. 2d 747 (Fla. Div. Ct. App. 1988); *Societe Generale v. Charles & Co. Acquisition, Inc.* 597 N.Y.S.2d 1004 (N.Y. App. Div. 1993).

174. *See, e.g.*, *Mut. Benefit Life Ins. Co. v. Frantz Klodt & Son, Inc.*, 237 N.W.2d 350 (Minn. 1975) (*per curiam*). *But see* *Travelers Ins. Co. v. Tritsch*, 438 N.W.2d 863 (Iowa Ct. App. 1989) (insolvency not required if mortgage specifically assigned rents as security).

175. GA. CODE ANN. § 9-8-3 (1994) ("manifest danger of loss, destruction, or material injury" regarding assets charged with payment of debt); IOWA CODE § 680.1 (1998) (loss or material injury to property or its rents and profits); KAN. STAT. ANN. § 60-1304 (1994) (immediate and irreparable injury likely to result absent appointment); KY. REV. STAT. ANN. § 381.420 (West 2002) (waste or threat of waste), *id.* § 425.600 (West 1992) (loss or material injury to property); MICH. COMP. LAWS ANN. § 600.2927 (2002) (receiver may be appointed to correct/prevent waste in form of non-payment of taxes/insurance); S.C. CODE ANN. § 15-65-10 (2005) (loss or material injury to property or its rents and profits); WIS. STAT. ANN. § 813.16(1) (West 1994) (loss or material injury to property or its rents and profits)

176. ARK. CODE ANN. § 16-117-208 (1999) (threat of material injury to land or mortgage default plus probable inadequacy of security); CAL. CIV. PROC. CODE § 564(b)(2) (West 1979, amended 1991) (threat of material injury to land or mortgage default plus probable inadequacy of security); COLO. REV. STAT. § 38-38-601 (2000) (inadequate security or threat of injury that could render security inadequate); IDAHO CODE ANN. §§ 8-601(2), 8-601(A)(2) (2004) (inadequate security or threat of injury/loss to property or its income); MONT. CODE ANN. § 27-20-102(2) (2005) (threat of material injury to land or mortgage default plus probable inadequacy of security); NEB. REV. STAT. § 25-1081 (1995) (threat of material injury or probable inadequacy of security); NEV. REV. STAT. § 32.010(2) (2003) (threat of material injury to land or mortgage default plus probable inadequacy of security); N.D. CENT. CODE § 32-10-

utes, however, authorize the appointment of a receiver without regard to the adequacy of the mortgagee's security or the mortgagor's solvency.¹⁷⁷

Moreover, there is significant state-to-state variation regarding whether the parties may circumvent any equitable or statutory limitations upon the appointment of a receiver by contractual stipulation. Assignments of rents commonly contain a clause whereby the mortgagor/assignor consents in advance to the appointment of a receiver (often on an *ex parte* basis) following default. In some states, statutes and/or court decisions have validated receivership clauses as a matter of law.¹⁷⁸ Courts in other states give receivership clauses evidentiary weight but do not make them determinative.¹⁷⁹ In other states, however, courts have refused to enforce such clauses as contrary to public policy.¹⁸⁰

The UARA attempts to address some of these inconsistencies, and codifies and/or clarifies the law regarding rent receiverships as follows:

- The *UARA* establishes clear jurisdictional predicates for receivership motions. Traditionally, receivership is an ancillary remedy that requires the moving party to have filed some other pending ju-

01(2) (1996) (threat of material injury to land or mortgage default plus probable inadequacy of security); OHIO REV. CODE ANN. § 2735.01(B) (LexisNexis 2000) (threat of material injury to land or mortgage default plus probable inadequacy of security); TEX. CIV. PRAC. & REM. CODE ANN. § 64.001 (Vernon 1997) (threat of material injury to land or mortgage default plus probable inadequacy of security); UT. R. CIV. P. 66(a)(1) (threat of material injury to land or mortgage default plus probable inadequacy of security); WYO. STAT. ANN. § 1-33-101(a)(iv) (2005) (threat of material injury to land or mortgage default plus probable inadequacy of security).

177. See, e.g., ARIZ. REV. STAT. ANN. § 33-702(B)(1) (2000) (court may appoint without regard to adequacy of security); WASH. REV. CODE ANN. § 7.60.025(1)(b)(ii) (1992 & Supp. 2004) (perfected assignment of rents sufficient to justify appointment); MINN. STAT. ANN. § 559.17(2) (2000) (court may appoint without regard to adequacy of security where agreement so provides).

178. 735 ILL. COMP. STAT. ANN. § 5/15-1702(b) (West 2003); IND. CODE ANN. § 32-30-5-1(4)(C) (West 2002); MINN. STAT. ANN. § 559.17(2) (West 2000) (mortgages of \$100,000 or more); N.Y. REAL PROP. LAW § 254(10) (McKinney 1989); OKLA. STAT. ANN. tit. 12, § 1551(2)(c) (West 1991); Fed. Home Loan Mortgage Corp. v. Nazar, 100 B.R. 555, 559 (D. Kan. 1989); Bank of Am. Nat'l Trust & Sav. Ass'n v. Denver Hotel Ass'n Ltd. P'ship, 830 P.2d 1138, 1139-40 (Colo. Ct. App. 1992); Fleet Bank of Maine v. Zimelman, 575 A.2d 731, 733-34 (Me. 1990); Metro. Life Ins. Co. v. Liberty Ctr. Venture, 650 A.2d 887, 891 (Pa. Super. Ct. 1994).

179. See, e.g., Wellman Sav. Bank v. Roth, 432 N.W.2d 697, 698-99 (Iowa Ct. App. 1988); Riverside Props. v. Teachers Ins. & Annuity Ass'n of Am., 590 S.W.2d 736, 738 (Tex. App. 1979); Barclays Bank of Cal. v. Superior Court, 137 Cal. Rptr. 743, 748 (App. 1977).

180. See, e.g., Dart v. W. Sav. & Loan Ass'n, 438 P.2d 407 (Ariz. 1968); Chromy v. Midwest Fed. Sav. & Loan Ass'n of Minneapolis, 546 So. 2d 1172, 1173 (Fla. Dist. Ct. App. 1989); Barclays Bank, P.L.C. v. Davidson Ave. Assocs., Ltd., 644 A.2d 685, 686-87 (N.J. Super. Ct. App. Div. 1994).

dicial action (*i.e.*, an action to which the receivership would be ancillary). In states that recognize only judicial foreclosure, the existence of a judicial foreclosure proceeding provides the action to which a receivership may be ancillary. In states that authorize power of sale foreclosure, however, a mortgagee may foreclose privately without any judicial proceeding.¹⁸¹ In these states, the lack of any pending action raises a concern about whether the mortgagee can obtain the “ancillary” remedy of a receivership. The UARA addresses this concern by making clear that the assignee can file an action for specific performance of the assignment of rents – which would provide a sufficient jurisdictional predicate for the appointment of a receiver even if the assignee chose to foreclose by power of sale.¹⁸²

- The *UARA establishes coherent uniform standards for the appointment of a receiver*. The UARA provides that an assignee is entitled to the appointment of a receiver if the assignor of rents is in default and either (1) the assignor has agreed to the appointment of a receiver after default, (2) the value of the mortgaged premises appears insufficient to satisfy the mortgage debt, (3) the UARA obligates the assignor to turn over to the assignee rents collected by the assignor, but the assignor has failed to do so, or (4) a subordinate assignee of rents obtains the appointment of a receiver.¹⁸³ A uniform standard should provide for more consistent treatment of similarly situated mortgagees.

- The *UARA confirms existing law regarding priority between conflicting receivers*. Where more than one rents assignee seeks the appointment of a receiver, the UARA provides a priority rule modeled upon Section 4.5 of the Restatement of Mortgages. The UARA’s general priority rules for conflicting assignments of rents are based upon time of recording.¹⁸⁴ Thus, if a senior assignee of rents is entitled to the appointment of a receiver, the court’s appointment of that receiver will take priority over and displace a prior receivership obtained by a subordinate assignee.¹⁸⁵ Any proceeds previously collected by the receiver for the subordinate as-

181. NELSON & WHITMAN, *supra* note 6, § 7.19, at 665.

182. UARA § 7(b)(2) & cmt. 1.

183. *Id.* § 7(a)(1). While nearly all situations justifying receivership will fall under one or more of these categories, UARA also preserves the traditional equitable discretion of judges to identify other circumstances justifying the appointment of a receiver. *Id.* § 7(a)(2) (court may appoint receiver if “other circumstances exist that would justify the appointment of a receiver under law of this state other than [UARA]”).

184. *Id.* § 5(b), (c).

185. *Id.* § 7(f)(1).

signee, however, need not be turned over to the receiver for the senior assignee, but would instead be applied by the junior receiver in the manner specified in its order of appointment.¹⁸⁶

The UARA does not address every conceivable issue involving rent receivers. For example, the UARA does not address whether an assignee of rents is entitled to the appointment of a receiver on an *ex parte* basis. Many commercial mortgage documents purport to authorize such *ex parte* appointments, and some courts have routinely granted receiverships without prior notice to the assignor.¹⁸⁷ The drafting committee chose to leave to judicial resolution or other legislation the question of whether (and in what circumstances) prior notice to the assignor is excused.¹⁸⁸ Likewise, the UARA does not specifically address the extent to which a receiver can terminate or disaffirm existing leases. In many states, statutory or case law regarding receiverships has generally established (or limited) the receiver's power to terminate leases in default or to disaffirm leases not in default.¹⁸⁹ Likewise, the court order appointing a receiver will often specify the extent to which a receiver can terminate or disaffirm existing leases with or without the approval of the court and/or the assignee. Accordingly, the drafting committee resolved to leave this issue to the terms of the court order appointing the receiver and other state law.¹⁹⁰

B. Enforcement by Notification to the Assignor and the Assignor's Liability for Failure to Comply with a Turnover Notification

Defaulting mortgagors sometimes engage in "milking" of rents – *i.e.*, collecting rents and using the proceeds for purposes unrelated to repayment of the mortgage or preservation of the mortgaged premises. Milking of rents that have been assigned as security poses a significant concern, particularly to an undersecured mortgagee that cannot expect full recovery of the mortgage debt via foreclosure. This concern is even more severe if the undersecured mortgage debt is nonrecourse, because the mortgagor will have no personal liability for a deficiency judgment. Such a threat often causes the mortgagee to take prompt action following default to enforce its interest in rents.

Between the time that the mortgagor defaults and the time the mortgagee effectively enforces its security interest in rents, the mortgagor has often collected rents and subsequently disposed of them. In this situation, the assignee may seek to recover the damages that it suffered because the mort-

186. *Id.* § 7(f)(2).

187. NELSON & WHITMAN, *supra* note 6, § 4.36, at 265.

188. UARA § 7 cmt. 7.

189. See RESTATEMENT (THIRD) OF PROP.: MORTGAGES § 4.4 (1997) (Reporter's Note) (collecting cases).

190. UARA § 7 cmt. 8.

gagor milked rents that might otherwise have reduced the mortgage debt. The common law treated such a mortgagor's conduct as a species of legal waste – consistent with its treatment of “rents” as an incorporeal hereditament in the nature of real property.¹⁹¹ However, many courts held that the mortgagor's expenditure of collected rents could only constitute waste if the mortgagee/assignee had taken sufficient steps to enforce its security interest in rents by divesting the mortgagor of control over those rents.¹⁹² Thus, as explained in Part II, most courts required the assignee of rents to become a mortgagee in possession, obtain the appointment of a receiver, obtain a judicial order requiring the sequestration of rents, or (in some cases) notify tenants to pay rentals directly to the assignee.¹⁹³ Under this view, it did not clearly suffice for the assignee merely to make a demand upon the assignor to turn over rents as the assignor collected them from tenants.

To a significant extent, this traditional reticence may have reflected a practical concern over the ostensible ownership problem that would exist while the mortgagor remained in possession of collected rents. Certainly, third party claimants – e.g., trade creditors to whom the mortgagor might transfer cash proceeds of collected rents in ordinary course transactions – could be easily misled by the mortgagor's control over that cash. However, existing doctrines (such as the negotiability of money) already provide sufficient protection for bona fide third parties that receive payments comprised of proceeds of rents.¹⁹⁴ The ostensible ownership problem alone should not negate the ability of the assignee to make an effective demand for the payment of rents collected by the assignor. Furthermore, a turnover demand could establish a clear and objective predicate for the assignor's liability for failure to comply with such a demand – even if other priority doctrines prevented the assignee from tracing its security interest into the hands of good faith transferees (such as employees or trade creditors of the assignor).

191. The common law generally imposed liability for waste upon a mortgagor for any affirmative action that damaged or destroyed the mortgaged real property, thereby reducing its value. In title theory jurisdictions, this liability extended to the full reduction in the collateral's value; under the lien theory, this liability existed only to the extent that the waste actually impaired the mortgagee's security. NELSON & WHITMAN, *supra* note 6, § 4.4, at 163-64.

192. *See, e.g.,* Taylor v. Brennan, 621 S.W.2d 592 (Tex. 1981) (mortgagor's collection and disposition of rents following mortgagee's enforcement of security interest in rents would constitute waste, but no waste occurred where mortgagee had not taken sufficient steps to enforce its security interest in rents).

193. *See supra* text accompanying notes 105-121.

194. *Cf.* U.C.C. § 9-332(a) (2001) (“A transferee of money takes the money free of a security interest unless the transferee acts in collusion with the debtor in violating the rights of the secured party.”); *id.* § 9-332(b) (“A transferee of funds from a deposit account takes the funds free of a security interest in the deposit account unless the transferee acts in collusion with the debtor in violating the rights of the secured party.”).

The Restatement of Mortgages first sought to address this problem by making clear an assignee can enforce its interest in rents by an effective turn-over demand upon the assignor,¹⁹⁵ thereby providing an objective predicate for the assignor's liability for failure to comply with the demand.¹⁹⁶ California's comprehensive assignment of rents statute provides a comparable result.¹⁹⁷ Consistent with these earlier reforms, the UARA provides that upon the assignor's default or as otherwise agreed by the assignor, "the assignee may give the assignor a notification demanding that the assignor pay over the proceeds of any rents that the assignee is entitled to collect."¹⁹⁸ If the assignor receives this notification and thereafter collects rents but fails to turn them over to the assignee, the assignor is liable to the assignee in the amount of the rents not turned over.¹⁹⁹

The assignor's liability under the UARA for failure to turn over rents is based upon harm to the assignee's security and is thus in the nature of liabil-

195. Section 4.2(c) of the Restatement provides:

The mortgage may provide that the mortgagee may commence collection of the rents at any time or, in any event, upon mortgagor default. The mortgagee's right to actual possession of the rents arises upon:

- (1) satisfaction of any conditions in the mortgage; and
- (2) delivery of a demand for the rents to the mortgagor, the holder of the equity of redemption, and each person who holds a mortgage on the real property or on its rents of which the mortgagee has notice.

RESTATEMENT (THIRD) OF PROP.: MORTGAGES § 4.2(c) (1997).

196. *Id.* § 4.6(a)(5) ("Waste occurs when, without the mortgagee's consent, the mortgagor . . . retains possession of rents to which the mortgagee has the right of possession . . .").

197. CAL. CIV. CODE § 2938(c)(4) (West 1993 & Supp. 2005) (amended 1996) ("The assignment shall be enforced by one or more of the following: . . . (4) Delivery to the assignor of a written demand for the rents, issues, or profits, a copy of which shall be mailed to all other assignees of record of the leases, rents, issues, and profits of the real property at the address for notices provided in the assignment or, if none, to the address to which the recorded assignment was to be mailed after recording.").

198. UARA § 8(a). The assignee must also give a copy of the notification to any other person that held a recorded assignment of rents on the land as of a date ten days prior to the notification date. *Id.*

199. *Id.* § 14(d). It is worth noting that UARA's measure of liability does not precisely duplicate the Restatement approach. In lien theory states, courts traditionally held that the mortgagor was liable for waste only to the extent that its conduct impaired the mortgagee's security. Rather than focusing upon impairment of security – which would require proof of the value of the mortgaged real property – UARA simply provides that the assignor is liable to the full extent of the rents that it was obligated but failed to turn over to the assignee. *Id.* § 14(d). UARA requires the assignee to apply any such recovery to reduction of the secured obligation, *id.* § 12, and thus the assignee's total recovery could not exceed the loss that the assignee actually suffered. *Id.* § 12(3). In the unlikely event that there remained a surplus after the assignee's full satisfaction, the assignee would be obligated to pay the surplus to the assignor or to subordinate lienholders in accordance with UARA § 12. *Id.* § 12(4)-(5).

ity for conversion; it is not liability on the debt itself in the nature of a deficiency judgment. Thus, a mortgagor that engaged in milking of rents could not avoid liability under the UARA simply because the underlying mortgage debt was nonrecourse, or because other state law limits the mortgagor's personal liability for repayment of the mortgage debt.²⁰⁰ The UARA does not specifically address whether an assignee of rents can contractually waive the assignor's liability for failure to turn over rents, but there appears to be no sound policy reason why sophisticated commercial parties could not knowingly contract for such a result.

C. Enforcement by Notification to Tenants

UCC Article 9 provides a firm statutory foundation for notification-based financing of accounts, chattel paper and payment intangibles. After default or as otherwise agreed by the debtor, an assignee of an account, chattel paper, or payment intangible can notify the account debtor to make payment or otherwise render performance directly to the secured party.²⁰¹ Upon receipt of such a notification, the account debtor must pay the secured party and cannot thereafter discharge its obligation through payment to the debtor.²⁰²

Because real property rents are essentially identical to accounts receivable,²⁰³ a comparable notification scheme is appropriate for an assignee seeking to enforce its security interest in real property rents. The common law of contracts, as reflected in Restatement (Second) of Contracts section 338,²⁰⁴ provides the general framework for enforcement by notification to tenants.

200. This is consistent with the weight of case authority. See, e.g., *Hoelting Enters. v. Nelson*, 929 P.2d 183, 187 (Kan. Ct. App. 1996); *Int'l Bus. Machs. Corp. v. Axinn*, 676 A.2d 552 (N.J. Super. Ct. App. Div. 1996) (per curiam). See also *Evergreen Ventures v. McDonald (In re Evergreen Ventures)*, 147 B.R. 751, 755 (Bankr. D. Ariz. 1992) (distinguishing deficiency action and waste action).

201. U.C.C. § 9-607(a)(1) (2001).

202. *Id.* § 9-404(a).

203. In fact, rents from real property are "accounts" under revised Article 9. "Account" includes any "right to payment of a monetary obligation . . . for property that has been or is to be sold, leased, licensed, assigned, or otherwise disposed of . . ." *Id.* § 9-102(a)(2)(i). Here, the term "property" is not limited solely to personal property, and the revisers made clear that the vendor's rights to installment payments under a contract for deed constitute an account within the meaning of Article 9. "Rents" would likewise fit this definition; however, Article 9's general exclusion of any security interest in land or rents from land makes it irrelevant that real property rents in fact fit within the definition of accounts.

204. See RESTATEMENT (SECOND) OF CONTRACTS § 338(1) (1981) ("[N]otwithstanding an assignment, the assignor retains his power to discharge or modify the duty of the obligor to the extent that the obligor performs or otherwise gives value until but not after the obligor receives notification that the right has been assigned and that performance is to be rendered to the assignee.").

The new Restatement of Mortgages implicitly recognized the mortgagee's capacity to enforce its interest in rents via direct notification to tenants, but did not elaborate on the third party implications of this remedy, choosing instead to incorporate by reference background contract law principles.²⁰⁵ By contrast, California's comprehensive assignment of rents statute provided more detailed provisions regarding the rights and obligations of tenants receiving such notifications – in part, based upon concern that such tenants may often lack the sophistication needed to understand the legal ramifications of notification.

The UARA recognizes the assignee's capacity to collect rents via direct notification to a tenant, and (similar to the California statute) provides moderately detailed provisions addressing the content and effect of such a notification. In particular:

- The *UARA* provides minimum content for the notification. The notification to a tenant must be signed by the assignee and: (1) identify the tenant, the assignor, the assignee, the premises, and the assignment of rents being enforced; (2) provide the recording data for the document creating the assignment of rents or other reasonable proof of the assignment; (3) state the assignee's right to collect the rents; (4) direct the tenant to pay the assignee all unpaid accrued rents and all unaccrued rents as they come due; (5) provide the name and telephone number of a contact person and an address to which the tenant can direct payment and any inquiry for additional information about the assignment or the assignee's right to enforce it; (6) describe the manner in which the UARA's provisions affect the tenant's payment obligations; and (7) state that the tenant may consult a lawyer if the tenant has questions about its rights and obligations.²⁰⁶

205. RESTATEMENT (THIRD) OF PROP.: MORTGAGES § 4.2 cmt. d (1997) ("This section does not delineate the rights and obligations of the lessee or other obligor after the mortgagee triggers the right to collect rents. A lessee may, for example, be concerned with the potential for double liability if it erroneously pays the mortgagee rather than [the] mortgagor. Such questions are to be resolved in accordance with Restatement, Second, Contracts § 338 . . .").

206. UARA § 9(a)(1)-(7). UARA adopts a media-neutral definition of "sign" that permits authenticated notification by electronic means in appropriate cases. *Id.* §§ 2(16), 3(a)(2). UARA also provides a "safe harbor" form notification. *Id.* § 10.

In addition to the tenant, the assignee must give a copy of the notification to the assignor and to "any other person that, 10 days before the notification date, held a recorded assignment of rents arising from the real property." *Id.* § 9(a). This would obligate an assignee enforcing its assignment of rents to conduct a record search and notify any senior or junior rents assignee. If the enforcing assignee failed to give notification to another recorded rents assignee, this failure would not defeat the effectiveness of the notification vis-a-vis the assignor and the tenants. *Id.* § 9(f).

- The *UARA* provides tenants with a reasonable period in which to obtain legal advice regarding the effect of notification. An assignee of rents may make a demand upon tenants just before the next month's rent falls due. A tenant receiving such a notification might understandably wish to seek legal advice regarding the effect of the notification, but might also reasonably fear that any delay in payment of rent could result in an argument that the tenant has breached its lease. To address this situation, the *UARA* provides that a tenant that receives a notification to pay rents to the assignee is not in default for nonpayment of rents accruing after the date the notification is received before the earlier of 10 days after the date the next regularly scheduled rent payment would be due or 30 days after the date the tenant receives the notification. In this way, the *UARA* provides a tenant with a reasonable period in which to delay payment while seeking legal advice, without the risk that such a delay could result in termination of the lease.²⁰⁷

- The *UARA* codifies existing law regarding the tenant's potential risk of "double payment," but with special protection for residential tenants. The *UARA* provides that upon receipt of a sufficient notification from the assignee, the tenant must pay the assignee in order to discharge its rental obligation, and also provides that the tenant's payment to the assignee satisfies the tenant's obligation under its lease to the extent of the payment.²⁰⁸ The tenant must continue to direct payment to the assignee until the assignee cancels its notification or the tenant receives a court order directing payment in a different manner.²⁰⁹ If the tenant occupies the premises as its primary residence, however, the tenant can discharge his or her rental obligation by paying *either the assignor or the assignee*.²¹⁰ In this respect, the *UARA* accords the residential tenant with more favorable treatment than Article 9 generally affords to consumer account debtors.²¹¹ The drafting committee concluded that such treatment was justified because residential tenants, especially unsophisticated ones, might be particularly likely to pay the assignor in good faith – either out of ignorance or, more likely, in

207. *Id.* § 9(d). This "grace period," so to speak, would not provide the tenant with any additional time in which to pay rents that had already accrued prior to the tenant's receipt of the notification.

208. *Id.* § 9(c)(1)-(3).

209. *Id.* § 9(c)(4).

210. *Id.* § 9(c)(2).

211. In terms of an account debtor's nondischarge for improperly directing payment to the assignor, U.C.C. § 9-404(a) makes no distinction between consumer and nonconsumer account debtors.

response to improper eviction threats from the assignor – and that such tenants ought not be at risk of eviction from their homes.²¹²

D. Collection of Rent and Payment of Operating Expenses

A commercial lease typically obligates the tenant to pay periodic sums to the landlord on account of property-related expenses such as real property taxes, insurance, and property maintenance – either the tenant's pro rata share of entire cost of taxes, insurance, and maintenance expenses, or the tenant's pro rata share of the increase in such costs or expenses beyond an established baseline amount. Leases customarily characterize the tenant's obligation to pay these sums as "rent" or "additional rent," and most assignment of rents documents include these sums as part of the "rents" assigned a security for the mortgage debt. Based upon these customary practices, the UARA defines the term "rents" to include amounts payable on account of these carrying costs of ownership.²¹³

Commercial mortgagees and tenants have substantial economic incentives to make sure that the mortgagor properly accounts for these carrying costs. A taxing authority's lien for unpaid real estate taxes typically primes both the mortgagee's lien and the tenant's leasehold interest.²¹⁴ Thus, foreclosure of a real estate tax lien directly threatens the security of each party's respective investment in the mortgaged premises. Likewise, if insurance premiums are unpaid, an uninsured casualty could destroy the mortgaged premises – and each party's respective investment in the premises. Finally, adequate property maintenance helps to maximize the likelihood that the property remains fully leased and thereby preserves the value of the property over time – again protecting the respective investments of the mortgagee and the tenants. The mortgagee thus has a substantial interest in making sure that taxes and insurance premiums are paid in a timely manner, and that appropriate property maintenance occurs (and is paid for) on a regular basis. For this reason, the mortgage document typically includes detailed covenants to ensure the mortgagor's timely performance of these responsibilities.²¹⁵

212. The UARA drafting committee recognized that this protection for residential tenants made it more problematic for an assignee to enforce its assignment of rents by notification to tenants in cases where the mortgaged premises is an apartment complex. Nevertheless, the committee concluded that the protection was justified because an assignee that wanted to preserve the potential liability of tenants could instead enforce its assignment of rents by obtaining the appointment of a receiver. UARA § 9 cmt. 2.

213. *Id.* § 2(12)(E) (rents includes "sums payable to an assignor for payment or reimbursement of expenses incurred in owning, operating and maintaining, or constructing or installing improvements on, real property").

214. NELSON & WHITMAN, *supra* note 6, § 4.45, at 293.

215. *See, e.g.*, R. WILSON FREYERMUTH, JOHN P. MCNEARNEY, DEBRA POGRUND STARK & DALE A. WHITMAN, ANATOMY OF A MORTGAGE: UNDERSTANDING AND NEGOTIATING COMMERCIAL REAL ESTATE LOANS 81-84, 107-10 (ABA 2001) (dis-

What happens, however, if the mortgagor defaults and the mortgagee begins collecting rents and “additional rents” directly from tenants? As noted above, the mortgagee has a substantial economic incentive to make sure that taxes and insurance are paid, and that adequate property maintenance continues. But is the mortgagee legally obligated to pay these expenses, or to apply “additional rents” paid by tenants to the payment of these expenses? Or may the mortgagee instead choose to apply those sums to the mortgage debt?

California’s comprehensive assignment of rents statute does impose an affirmative duty on the assignee to use any rents that it collects to pay the reasonable expenses of operating and maintaining the real property.²¹⁶ For a variety of reasons, this is arguably a sensible duty to impose upon the mortgagee. First, because mortgagees typically do use collected rents to pay these expenses, such a rule arguably tracks standard commercial practice. Second, if the mortgagee uses a receiver to collect rents, the receivership order typically requires the receiver to apply collected rents to the costs of operating and preserving the real property anyway. Finally, tenants certainly have a substantial practical expectation that additional rents will be applied to the payment of taxes, insurance, and maintenance in a fashion that preserves the tenant’s expected bargain regarding the property.

Nevertheless, the traditional rule prevailing in all other states is to the contrary. The landlord’s obligation to pay taxes, insurance, and maintenance expenses – even if that obligation is expressed or implied into its tenant leases – does not bind the mortgagee as a successor until the mortgagee acquires possession or ownership of the real property (by becoming a mortgagee in possession or purchasing the premises at foreclosure). If a mortgagee purchases the real property at foreclosure, the mortgagee then becomes obligated to fulfill the assignor’s responsibilities under the tenant leases that survive the foreclosure,²¹⁷ as the landlord’s covenants in those leases run with the real property to bind the mortgagee as successor landlord. Likewise, if the mortgagee becomes a “mortgagee-in-possession” prior to foreclosure, the common law imposes a duty upon the mortgagee to apply collected rents to the

cussing paragraphs 15 and 19 of the Fannie Mae uniform deed of trust form for multi-family housing).

216. CAL. CIV. CODE § 2938(g)(1) (West 1993 & Supp. 2005) (amended 1996).

217. Because the foreclosure sale transfers title to the sale purchaser of the same quality as existed on the date that the mortgage was granted, *see* NELSON & WHITMAN, *supra* note 6, § 7.17, at 663, a foreclosure sale would generally extinguish leases that were entered into after the mortgage was granted but would not affect leases that were entered into prior to the date the mortgage was granted. Frequently, however, subordinate leases remain unaffected by a foreclosure sale either as a function of express or implied nondisturbance and attornment agreements between the mortgagee and the tenants. For further discussion, *see* GRANT S. NELSON & DALE A. WHITMAN, *REAL ESTATE TRANSFER, FINANCE & DEVELOPMENT: CASES AND MATERIALS* 352-56 (6th ed. 2003).

preservation of the mortgaged premises.²¹⁸ But if the mortgagee merely collects rents that accrue prior to foreclosure – without taking either actual or constructive possession of the real property – prevailing law permits the mortgagee to apply those rents to the mortgage debt without legal obligation to pay taxes, insurance, or maintenance expenses. Prior to foreclosure, the mortgagee is not a successor that is bound to perform the landlord's covenants under tenant leases. Furthermore, courts have consistently refused to treat additional rent payments, escrow payments and the like as being impressed with a “trust” that creates any affirmative obligation on the mortgagee with respect to the application of such funds.²¹⁹

The initial draft of the UARA – which was based in significant part upon the template established by California's assignment of rents statute – would have obligated the mortgagee to apply collected rents to the reasonable expenses of maintaining the property.²²⁰ Over the course of several meetings, however, the drafting committee eventually concluded that the UARA should codify the prevailing rule that the mortgagee's collection of rents does not by itself affirmatively obligate the mortgagee to apply those rents to property

218. NELSON & WHITMAN, *supra* note 6, § 4.27, at 230-31.

219. *Id.* § 4.18, at 204-07 (discussing prevailing judicial treatment of mortgage escrow accounts). In fact, courts traditionally have held that a landlord does not even hold a tenant's *security deposit* subject to any implied trust, but that the deposit creates only a simple debt owing from the landlord to the tenant. *See generally* R. Wilson Freyermuth, *Are Security Deposits “Security Interests”? The Proper Scope of Article 9 and Statutory Interpretation in Consumer Class Actions*, 68 MO. L. REV. 71, 81-84 (2003). Statutory reform in some states now imposes a trust or trust-like responsibility upon the landlord for handling of tenant security deposits, and this responsibility would extend to an assignee that took control over security deposits. Outside of California, however, mortgagees have no similar statutory trust or trust-like responsibility for handling additional rents paid by tenants.

220. Section 12 of the December 2003 meeting draft provided as follows:

(a) If the assignee collects any rents following enforcement of an assignment of rents . . . , the assignor or any other person holding a recorded assignment of rents on the real property may deliver to the assignee a notification demanding that the assignee pay the reasonable costs of protecting and preserving the real property, including payment of taxes and insurance.

(b) Following receipt of a notification under subsection (a), the assignee shall pay for the reasonable costs of protecting and preserving the real property to the extent of any rents actually received by the assignee. This obligation shall continue until the date on which the assignee obtains the appointment of a receiver . . . or the date on which the assignee ceases to enforce the assignment, whichever occurs first.

(c) Nothing in this Section shall require the assignee to operate or manage the real property, which obligation shall remain that of the assignor.

Uniform Mortgagee Access to Rents Act § 12 (Discussion Draft 2003), *available at* <http://www.law.upenn.edu/bll/ulc/maripp/dec2003mtgdraft.htm> (last visited Feb. 9, 2006).

operating expenses.²²¹ The committee was motivated in part by prudential concerns – *i.e.*, the desire to avoid a potential objection to enactment from the mortgage lending industry. However, one might also justify the committee’s decision by simply recognizing that in this situation, practicality may dominate the lack of obligation. In the typical case, a mortgagee that does collect additional rents directly from tenants will apply those sums (if necessary) to the payment of taxes, insurance, and maintenance expenses to protect its own economic interest, despite having no affirmative legal obligation to do so.

Another reason why a prudent mortgagee will apply collected rents to the payment of property-related expenses is to avoid any possible claim or defense that a tenant might have to payment of rent based upon the landlord’s nonperformance of the lease agreement. In some cases, the landlord’s failure to maintain the property as specified in the lease will breach the lease. In some cases, this breach may give the tenant a defense to payment of rents (*e.g.*, if the lease gives the tenant a right to terminate the lease following uncured landlord defaults); in other cases, the breach may give the tenant an affirmative claim for damages that the tenant might use as a basis for claiming an offset against accrued rents. The UARA makes clear that while a mortgagee has no affirmative duty to apply collected rents to the payment of property-related expenses, the mortgagee’s right to collect rents from tenants is “subject to the terms of the agreement between the assignor and tenant and any claim or defense arising from the assignor’s nonperformance of that agreement,” unless the tenant has made an enforceable agreement not to assert claims or defenses against the mortgagee.²²² The UARA adopts this position so as to be least disruptive of the contractual expectations of mortgagees and tenants. If the lease provides the tenant with the basis for a claim or defense regarding rent payments and the tenant has not agreed to waive such claims and defenses, the UARA preserves the tenant’s ability to raise such claims or defenses if the mortgagee attempts to collect rents directly from the tenant. However, if the tenant has agreed to waive such claims or defenses – as mortgage lenders commonly require many tenants to do by executing sub-

221. UARA § 13(a) (“Unless otherwise agreed by the assignee . . . , an assignee that collects rents following enforcement . . .” by notification may apply the proceeds in accordance with UARA’s distribution scheme and “need not apply them to the payment of expenses of protecting or maintaining the real property subject to the assignment.”).

222. *Id.* § 13(b). This provision is substantially comparable to the analogous Article 9 provision regarding a secured party’s rights against an account debtor. See U.C.C. § 9-404(a) (“Unless an account debtor has made an enforceable agreement not to assert defenses or claims, . . . the rights of an assignee are subject to . . . all terms of the agreement between the account debtor and assignor and any defense or claim in recoupment arising from the transaction that gave rise to the contract . . .”).

ordination, nondisturbance and attornment agreements (SNDAs) – the mortgagee can enforce that waiver.²²³

E. Priority Among Competing Rent Assignments

The owner of a commercial real estate development may obtain two or more mortgage loans, each also secured by assignments of rents. In the event of a default, each such mortgagee/assignee may independently act to enforce its respective security interest in rents. In this situation, state law must provide a priority rule to resolve the conflicting claims of each mortgagee/assignee. Generally speaking, each state's recording statute provides the default priority rule for conflicting claims to real estate. As a result, an earlier assignment of leases and rents will (if properly recorded) have priority over a subsequent assignment with respect to both unaccrued and accrued but unpaid rents. The UARA codifies this result.²²⁴

It is possible, of course, that a junior assignee may take action to collect rents (either directly or through the appointment of a receiver) before a senior assignee has taken steps to enforce its interest in rents. In these situations, a junior assignee may collect rents from tenants for one or more periods before it receives notification that the senior assignee is enforcing its rights. When the junior assignee learns of the senior's enforcement, must the junior assignee turn over any rents that it collected before it received notification of the senior's enforcement efforts?

The Restatement (Third) of Property – Mortgages addressed this priority question in the context of priorities between competing receivers. Section 4.5(b) provides that a receiver appointed under a junior mortgage has the right to collect rents until a receiver is appointed by the senior mortgagee and to apply those rents to the balance of the junior mortgage obligation (rather than the senior mortgage debt).²²⁵ The Restatement authors took the view that

223. UARA also recognizes that a tenant may have standing to seek the appointment of a receiver for the real property or other relief if the mortgagee's nonpayment of property-related expenses has caused or threatened harm to the tenant's leasehold interest. UARA § 13(c). The Act does not establish that such a tenant has a legal right to such relief, but leaves this issue to other law of the state and to judicial resolution on a case-by-case basis. *Id.* § 13 cmt. 3.

224. *Id.* § 5(c) (“[A] perfected security interest in rents takes priority over the rights of a person that, after the security interest is perfected . . . purchases an interest in the rents or the real property from which [they] arise.”). UARA defines “purchase” to include taking an interest in a voluntary transaction, *id.* § 2(11), and thus a subsequent rents assignee would be a purchaser within the meaning of section 5(c).

225. RESTATEMENT (THIRD) OF PROP.: MORTGAGES § 4.5(b) (1997) (“When a junior mortgagee obtains the appointment of a receiver, that receiver has the right, until a receiver is appointed under a senior mortgage, to collect rents from the mortgaged real estate and, after first using them to pay real estate taxes and other reasonable expenses associated with the maintenance and repair of the real estate, to apply

this result “rewards the diligent junior mortgagee” and did not harm the senior mortgagee that had as yet not taken steps to enforce its interest in rents.²²⁶ California’s comprehensive assignment of rents statute provides a similar result, even in cases where the junior mortgagee has enforced its interest in rents by direct collection rather than through a receivership.²²⁷ Although there is some contrary authority requiring the junior mortgagee to turn over net rents collected upon a demand by the senior mortgagee,²²⁸ the weight of the moderate case authority allows the junior mortgagee to retain rents collected in good faith prior to receiving notification from the senior assignee.²²⁹ The UARA codifies this position,²³⁰ which is also consistent with Article 9’s treatment of conflicting security interests in cash proceeds of receivables.²³¹

the balance to the junior mortgage obligation.”). Section 4.5(b), however, does not address the situation where a senior mortgagee/assignee seeks to enforce its assignment by means other than the appointment of a receiver.

226. *Id.* § 4.5 comment b (“This preference for the junior mortgagee . . . rewards the diligent junior mortgagee. Had the latter not sought the appointment of a receiver, the rents that accrued prior to the appointment of the senior mortgage receiver would have gone to the mortgagor and not to the senior lienholder. Thus, allowing the junior mortgagee to reap the benefit of those rents places the senior mortgagee in no worse a position than would have been the case had the junior mortgagee failed to act.”).

227. California’s statute provides, in pertinent part:

[I]f an assignee who has recorded its interest in leases, rents, issues, and profits prior to the recordation of such interest by a subsequent assignee seeks to enforce its interest in those rents, issues, or profits in accordance with this section after any enforcement action has been taken by a subsequent assignee, the prior assignee shall be entitled only to the rents, issues, and profits that are accrued and unpaid as of the date of its enforcement action and unpaid rents, issues, and profits accruing thereafter. The prior assignee shall have no right to rents, issues, or profits paid prior to the date of the enforcement action, whether in the hands of the assignor or any subsequent assignee.

CAL. CIV. CODE § 2938(h) (West 1993 & Supp. 2005) (amended 1996).

228. *See, e.g.,* *Bergin v. Robbins*, 146 A. 724 (Conn. 1929); *N.J. Title & Guarantee Co. v. Cone & Co.*, 53 A. 97 (N.J. 1902).

229. *See, e.g.,* *Stevens v. Blue*, 57 N.E.2d 451 (Ill. 1944); *Detroit Props. Corp. v. Detroit Hotel Co.*, 242 N.W. 213 (Mich. 1932); *Goddard v. Clarke*, 116 N.W. 41 (Neb. 1908); *Vecchiarelli v. Garsal Realty, Inc.*, 443 N.Y.S.2d 622 (N.Y. Sup. Ct. 1980).

230. UARA § 14(f).

231. As long as a party with a junior security interest in receivables acts in good faith and does not collude with the debtor to violate the rights of the senior, the junior can collect and the cash proceeds of those receivables and apply them to the debt free of the conflicting claim of a senior secured party. *See* U.C.C. § 9-331 cmt. 5 (2001). Thus, a junior secured party could obtain priority in receivables collections if it acted in good faith (which includes both “honesty in fact” and “observance of reasonable commercial standards of fair dealing,” *id.* § 1-201(b)(20)), which it could do if it did

The UARA also makes clear that competing rents assignees are free to make intercreditor agreements modifying their respective priorities as to rents or proceeds of rents.²³²

F. Priority Between Rents Assignees and Article 9 Secured Parties

The common law traditionally treated “rent” as an incorporeal hereditament in the nature of real property.²³³ As a result, the law has required that a security interest in “rents” must be created by a document that satisfies real estate law’s conveyancing formalities, and that this document must be recorded on the land records in order to make the assignee’s interest in rents effective against third parties. Yet, while the law has traditionally characterized rents as realty, this characterization is in a significant sense only temporary. When rent becomes due and the tenant pays it, the “rent” typically takes the form of cash (or a cash equivalent such as a check or funds on bank deposit) – which the law has always characterized as personal property.

The temporary nature of “rents” creates the possibility for priority conflicts between creditors whose interests arise under entirely different systems. For example, suppose that Borrower has granted to Mortgage Bank a mortgage on Blueacre and an assignment of rents arising from it, but has also granted Secured Party an effective Article 9 security interest in all of its assets. Both Mortgage Bank and Secured Party have taken all necessary steps to make their respective interests effective against third parties. Borrower’s tenant pays its monthly rent on Blueacre by check, but before the check is cashed, Borrower defaults. Who has first priority in the check – Mortgage Bank, by virtue of its assignment of rents, or Secured Party, by virtue of its Article 9 security interest in the check?

Because the UARA preserves the traditional conception that “rent” is in the nature of realty,²³⁴ the UARA must provide priority rules to address the potential conflicts between a rents assignee and another person claiming an interest in the proceeds of rents by virtue of Article 9. To ensure the proper coordination of the UARA with Article 9, the UARA provides as follows:

not know that its collection of the receivables would violate the rights of the senior secured party. *See id.* § 9-332(a), (b).

232. UARA § 16 (“[UARA] does not preclude subordination by agreement as to rents or proceeds.”).

233. *See supra* note 48 and accompanying text.

234. As discussed in Part II, several commentators have urged that Article 9 should treat rents as personal property collateral. Revised Article 9 decided to retain the traditional exclusion of security interests in land and rents from land, and there appears to be no impetus for further revision to Article 9. Thus, the UARA drafting committee opted to leave the creation and enforcement of an assignment of rents to the domain of real estate.

• *An assignee's perfected security interest in rents extends automatically to identifiable proceeds of the rents.*²³⁵ The UARA defines "proceeds" to mean any "personal property that is received or collected on account of a tenant's obligation to pay rents."²³⁶ Thus, if an assignor collects rents from tenants, an assignee that held a perfected security interest in those rents will have a security interest in whatever personal property the assignor receives in payment of the rents – whether cash or noncash – so long as the proceeds are identifiable.²³⁷ The assignee's interest in identifiable cash proceeds remains perfected if its interest in the rents was properly perfected.²³⁸

• *As a general matter, the UARA treats the assignee's interest in proceeds of rents as if that interest had arisen under Article 9, and then applies Article 9's priority rules.*²³⁹ This general rule reflects that once rents are transformed into personal property, the application of Article 9's priority rules is appropriate – at that point, third parties would logically look to the Article 9 system to create, perfect, and enforce a security interest in property of that type. For example, suppose that Borrower has assigned its rents to Assignee. Borrower thereafter collects rents from Tenant in cash, and uses that cash to pay Supplier for office supplies. Under Article 9, a transferee of money (such as Supplier) would take the money free of a conflicting security interest unless the transferee had acted in collusion with the transferor to violate the rights of the secured

235. UARA § 14(b)(2).

236. *Id.* § 2(10).

237. For determining whether commingled cash proceeds are "identifiable," UARA adopts the same standard used for identifiability of commingled cash proceeds under U.C.C. § 9-315(b)(2). UARA § 14(c) (cash proceeds are identifiable "to the extent the assignee can identify them by a method of tracing, including application of equitable principles, that is permitted under law of this state other than [UARA] with respect to commingled funds").

238. UARA § 15(b). *Accord* U.C.C. § 9-315(d)(2) (2005) (perfected security interest in collateral extends continuously to identifiable cash proceeds). In the unlikely event that a tenant paid its rent in the form of noncash proceeds, the assignee's security interest in the noncash proceeds would remain perfected only if the assignee perfects that interest in accordance with Article 9. UARA § 15(b). Thus, for example, if the tenant transferred a piece of equipment to the landlord in satisfaction of its rental obligation, the assignee would have a security interest in the equipment as identifiable proceeds of rents, *Id.* § 14(b)(2), but the assignee could perfect this interest only by filing a U.C.C.-1 financing statement covering the equipment or by taking possession of the equipment. *Id.* § 15(b).

239. UARA § 15(c) ("Except as otherwise provided in subsection (d), priority between an assignee's security interest in identifiable proceeds and a conflicting interest is governed by the priority rules in Article 9.").

party.²⁴⁰ As the UARA incorporates this priority rule, Supplier would take the cash free of Assignee's otherwise perfected security interest in those funds, so long as Borrower and Supplier did not act in collusion for the purpose of violating Assignee's rights.²⁴¹

- *An assignee's perfected security interest in identifiable cash proceeds will have priority over a conflicting interest arising under Article 9 if the Article 9 secured party perfected its interest by a means other than control.*²⁴² In most circumstances, an Article 9 secured party will perfect its security interest in cash or cash equivalents (such as funds in a deposit account) by means of control. In such cases, a secured party would take priority over the conflicting interest of a rents assignee in the same funds under the default rule set forth above. However, if the Article 9 secured party's interest was perfected by a means other than control (e.g., by filing or automatic perfection), the UARA provides that the rents assignee's perfected interest in the proceeds would take priority. For example, suppose that Borrower has assigned its rents to Assignee. Borrower thereafter collects rents from Tenant by check, and deposits the check into a deposit account maintained at Bank. Secured Party has an enforceable security interest in all of Borrower's present and after-acquired assets, perfected by filing. If Secured Party has established control over Borrower's deposit account at Bank, then Secured Party has priority over Assignee with respect to the deposited funds.²⁴³ But if Secured Party has not established control over Borrower's deposit account, then Secured Party's interest is perfected only by virtue of its initial filing (with respect to the check) and automatic perfection (as to the cash proceeds of the check) – and Assignee would thus take priority with respect to the proceeds of the check.²⁴⁴

In light of these provisions, a prudent assignee of rents would presumably not only obtain and record an assignment of rents arising from the mortgaged premises, but might also require the assignor to deposit all rent funds into a deposit account established specifically for that purpose (a "lockbox"), and on which the assignee was identified as the bank's customer. These additional steps would be sufficient under Article 9 (and thus under the UARA) to give the assignee priority over a conflicting Article 9 security interest claimed

240. U.C.C. § 9-332(a) (2001).

241. UARA § 15 cmt. 4, illus. 7.

242. *Id.* § 15(d).

243. *Id.* § 15 cmt. 4, illus. 3.

244. *Id.* § 15 cmt. 4, illus. 2.

by another creditor (including the bank at which the deposit account is maintained).²⁴⁵

G. Enforcement of an Assignment of Rents and Mortgagee-in-Possession Status

A mortgagee can enforce its interest in rents by taking physical possession of the mortgaged premises and thereby becoming a "mortgagee-in-possession." Most mortgagees are reluctant to do so, however, given the legal responsibilities and the potential financial liabilities associated with that status. A mortgagee that takes possession of the mortgaged premises becomes liable in tort for injuries caused by the mortgagee's own conduct or by the mortgagee's failure to carry out duties of care imposed upon the owner of land.²⁴⁶ In addition, a mortgagee in possession has an affirmative duty to manage the premises in a "reasonably prudent and careful" fashion for the benefit of the mortgagor and junior encumbrancers.²⁴⁷ As a result, most mortgagees prefer to enforce assignments of leases and rents through mechanisms designed to establish "constructive" possession over the rents without assuming actual physical possession of the land. Most typically, mortgagees have accomplished this by obtaining a receiver or notifying tenants to make rental payments directly to the mortgagee/assignee.

The weight of case authority establishes that these steps (collecting rents by means short of actual physical possession of the land) do not render the mortgagee/assignee as a "mortgagee in possession" with the consequent liabilities attendant to that status.²⁴⁸ California's statute also makes clear that enforcement via appointment of a receiver, direct notification to tenants, or direct notification to the mortgagor/assignor does not, by itself, render the mortgagee as a mortgagee-in-possession.²⁴⁹ Consistent with this approach, the

245. U.C.C. § 9-327(4) (2001). By becoming the customer on the deposit account, the assignee would obtain priority over a conflicting security interest claimed by the bank holding the deposit account. *Id.* § 9-327(4) (security interest in deposit account perfected by secured party's becoming customer on that account has priority over conflicting security interest held by the bank with which that account is maintained). Likewise, if that deposit account is also established specifically for the purpose of collecting assigned rents, then it would be impossible for another creditor other than the bank to obtain a conflicting security interest entitled to priority over the assignee. *Id.* § 9-327(2) (security interests perfected by control rank in priority according to time of obtaining control).

246. NELSON & WHITMAN, *supra* note 6, § 4.26, at 228.

247. *See, e.g.,* ComFed Sav. Bank v. Newtown Commons Plaza Assoc., 719 F. Supp. 367, 375 (E.D. Pa. 1989).

248. *See, e.g.,* RESTATEMENT (THIRD) OF PROP.: MORTGAGES § 4.2 cmt. c. (1997); Prince v. Brown, 856 P.2d 589, 590 (Okla. Civ. App. 1993).

249. *See, e.g.,* CAL. CIV. CODE § 2938(e)(1) (West 1993 & Supp. 2005) (amended 1996).

UARA provides that the mere enforcement of an assignment of rents by one of these methods does not render the assignee a mortgagee in possession.²⁵⁰

H. Enforcement of an Assignment of Rents and the Impact of "One-Action" Rules

In California and several other states, existing legislation establishes the "one-action" principle, under which a mortgagee is limited to one type of action for the enforcement of the mortgage debt.²⁵¹ The "one-action" principle serves to protect the mortgagor against potentially abusive enforcement action, as it essentially forces the mortgagee to initiate its recovery effort through foreclosure – thus permitting the mortgagee to recover any deficiency claim only in the context of the foreclosure proceeding.²⁵² If the mortgagee instead first brings an action to enforce the debt, courts have invoked the one-action principle to conclude that the mortgagee has made an election of remedies and has waived the ability to enforce its mortgage lien via foreclosure.²⁵³

Typically, an assignee of rents enforces its interest in rents in the context of a foreclosure. Accordingly, the mere enforcement of an assignment of rents should not implicate the one-action principle so as to compromise the assignee's other enforcement rights with respect to the mortgage debt. California's comprehensive assignment of rents statute clearly articulated this view, providing that an assignee's collection of rents under the statute did not "[c]onstitute an action, render the obligation unenforceable, violate Section 726 of the Code of Civil Procedure [the "one-action" rule] or, other than with respect to marshaling requirements, otherwise limit any rights available to the assignee with respect to its security."²⁵⁴ Consistent with this approach, the UARA likewise provides that an assignee's collection of rents does not violate the one-action principle, constitute an election of remedies that precludes

250. UARA § 11(1).

251. *See, e.g.*, CAL. CIV. PROC. CODE § 726(a) (West 1980); IDAHO CODE ANN. § 6-101 (2004); MONT. CODE ANN. § 71-1-222 (2005); NEV. REV. STAT. § 40.430 (2003); UTAH CODE ANN. § 78-37-1 (2002).

252. As Professors Nelson and Whitman explain:

The purpose of this rule is two-fold. One is to protect the mortgagor against multiplicity of actions when the separate actions, though theoretically distinct, are so closely connected that normally they can and should be decided in one suit. The other is to compel a creditor who has taken a mortgage on land to exhaust the security before attempting to reach any unmortgaged property to satisfy the claim.

NELSON & WHITMAN, *supra* note 6, § 8.2, at 739.

253. *See, e.g.*, Walker v. Cmty. Bank, 518 P.2d 329, 331 (Cal. 1984).

254. CAL. CIV. CODE § 2938(e)(2) (West 1993 & Supp. 2005) (amended 1996).

later enforcement of the secured obligation, or bar the assignee from obtaining a deficiency judgment following enforcement of the mortgage.²⁵⁵

CONCLUSION

With the rapid expansion of securitization, it has become increasingly clear that rents are functionally comparable to other forms of receivables. While commercial law has long possessed a clear and uniform structure governing the creation, perfection, and enforcement of security interests in most receivables (UCC Article 9), the law governing the creation, perfection, and enforcement of security interests in rents has drifted without a comparable statutory foundation. This lack of clarity has affirmatively promoted litigation over control of rents, particularly in the bankruptcy context. Over the past 20 years, untold millions of dollars have been effectively wasted as mortgage lenders, borrowers, and bankruptcy trustees have fought over control of rents generated by mortgaged real estate.

Most of this waste could have been avoided if commercial law had adopted comprehensive statutory rules governing security interests in rents. The new UARA provides this much-needed statutory foundation. As explained in this Article and as summarized in the Appendix, the UARA provides a comprehensive set of rules governing the creation, perfection, and enforcement of security interests in rents that are comparable to the corresponding Article 9 rules for personal property receivables. The UARA's prompt enactment by state legislatures will bring long-overdue clarity to the law of security in rents and further advance the cause of synthesis and coherence in the law of real and personal property finance.

255. UARA § 11(3)-(7). UARA also makes clear that an assignee's action against the assignor for failure to turn over rents under UARA § 14(d) does not violate the one-action principle or otherwise limit the assignee's rights with respect to enforcement of the secured obligation. *Id.*

APPENDIX

The Uniform Assignment of Rents Act (UARA), promulgated by the National Conference of Commissioners on Uniform State Laws in July 2005, provides a comprehensive framework to govern the creation, perfection, and enforcement of security interests in rents arising from mortgaged real property. Without such a comprehensive statutory framework, courts (particularly bankruptcy courts) have struggled to establish clear and consistent rules governing security interests in rents – thereby encouraging needless and wasteful litigation over control of rents arising from mortgaged real property. Enactment of UARA in each state will provide much-needed clarity by establishing the following rules:

- *“Rents” include sums payable for the right to possess or occupy the real property of another person, even if the occupant does not technically constitute a “tenant” under real property law.* In some commercial real estate developments (such as hotels and marinas), the occupants or “end-users” are not tenants under real property law, because their occupancy agreement does not create a sufficiently “exclusive” or “possessory” right. For this reason, some courts have refused to treat hotel room charges as “rents” and have thus concluded that hotel room charges would not be covered by an assignment of rents – even though such charges are functionally analogous to rents and parties often executed an assignment of rents believing that it covered such charges. UARA helps to resolve this documentary “trap,” by providing that “rents” includes any sums payable for the right to possess or occupy the real property of another person. UARA § 2(12).
- *A mortgage automatically creates a security interest in rents.* Under the title theory of mortgages, a mortgage automatically effected an assignment of rents from the mortgaged real property. Under the lien theory of mortgages, however, a mortgage did not automatically create an assignment of rents. By contrast, under Article 9 of the Uniform Commercial Code, a security interest in collateral automatically extends to all identifiable proceeds of the collateral (including sums received from leasing collateral). Recognizing the functional similarity between “rents” and “proceeds,” UARA provides that an effective mortgage automatically creates a security interest in rents arising from the mortgaged real property, unless the mortgage expressly provides otherwise. UARA § 4(a).
- *A security interest in rents is perfected (and thus enforceable against creditors and purchasers) upon recording of the document creating an assignment of rents.* Under Article 9, the filing of a fi-

nancing statement is sufficient to perfect a security interest in most forms of personal property. By contrast, some courts have held that even if a creditor held a recorded assignment of rents, the creditor held only an “inchoate” lien until the creditor actually collected the rents after default. Many of these courts further held that if the debtor filed for bankruptcy before the creditor took effective steps to collect the rent after default, the creditor’s interest was unperfected and the bankruptcy trustee could set aside the creditor’s interest in rents using the trustee’s strong-arm power. UARA overrules these decisions, providing that the recording of a document creating an assignment of rents is sufficient to perfect the creditor’s security interest in rents and thereby make that interest enforceable against subsequent creditors and purchasers. UARA § 5(a)-(c).

- *A security interest in rents is separate and distinct from a security interest in the underlying real property.* The primary purpose of an assignment of rents is to create an effective security interest in rents that accrue after the assignor’s default and prior to the assignee’s completion of a foreclosure sale of the mortgaged real property. Most courts have treated these rents as a source of collateral that is separate and distinct from the underlying land. A few notorious bankruptcy court decisions, however, have held that rents are “subsumed within the land” such that a debtor need not provide adequate protection of the assignee’s security interest in rents. UARA would overrule these decisions (to the extent that they rely upon state law), providing that a security interest in rents is an additional source of collateral that is distinct from the underlying real estate. UARA § 4(b).

- *There is no such thing as an “absolute assignment of rents” in the context of a mortgage transaction; an assignment of rents creates only a security interest in the rents.* Properly understood, an assignment of rents creates only a security interest in rents as collateral for the mortgage debt. Courts in some states, however, have held (and continue to hold) that an assignment of rents that purports to be an “absolute assignment” passes full title to the rents to the assignee, even prior to the assignor’s default. UARA would overrule these decisions, providing that any assignment of rents granted in the context of a mortgage transaction creates only a security interest in rents (regardless of its form). UARA § 4(b).

- *In a mortgage or assignment of rents, a provision granting the assignee the right to obtain a receiver following the assignor’s default is enforceable.* In many states, statutes provide few (if any) standards to inform a court’s exercise of discretion whether to appoint a receiver to collect rents from mortgaged real property.

UARA establishes consistent standards to govern the appointment of a receiver for mortgaged real property. UARA § 7(a). In particular, UARA establishes the enforceability of a clause by which the assignor has agreed that the assignee can obtain the appointment of a receiver after the assignor's default. UARA § 7(a)(1)(A).

- *Upon default by the assignor (or as otherwise agreed by the assignor), the assignee may collect all rents that have accrued but remain unpaid and all rents that accrue thereafter.* UARA § 6(b). By its terms, UARA does not allow the assignee to require the assignor to turn over sums already collected from its tenants prior to enforcement by the assignee. However, an assignee could create, perfect, and enforce a security interest in such monies under the provisions of UCC Article 9.

- *The assignee may enforce an assignment of rents by obtaining the appointment of a receiver, by notification to the assignor, by notification to the assignor's tenants, or by any other method permitted by other law.* UARA provides specific rules governing the collection of rents by receivership, by notification to the assignor, and by notification to tenants. UARA also provides that an assignee could collect rents by any other method permitted by law (including by becoming a mortgagee-in-possession). UARA §§ 6(a), 7, 8, 9.

- *The assignee's enforcement of its rights and remedies under UARA does not render the assignee as a "mortgagee in possession" or trigger other adverse statutory consequences.* At common law, a creditor that collected rents after default risked a possible argument that the creditor had become a "mortgagee in possession" – thereby triggering fiduciary obligations to the assignor and potential tort liability to third parties. UARA provides that the assignee's mere exercise of UARA's statutory remedies does not render the assignee as a mortgagee in possession. UARA § 11(1). Further, it does not constitute an election of remedies, render the mortgage debt unenforceable, violate a state's "one-action" principle, or trigger the application of a state's anti-deficiency statute. UARA § 11(2)-(7).

- *An assignor that collects rents after it receives notification that the assignee has enforced its security interest in rents must turn over to the assignee the rents collected; if the assignor fails to do so, it is liable to the assignee for the amount not turned over.* At common law, an assignor that refused to turn over rents to the assignee despite proper demand by the assignee could be held liable for "waste" (or conversion) of rents. The amount of such liability,

however, varied depending upon whether the jurisdiction followed the lien theory of mortgages (damages recoverable only to the extent assignee's security was impaired) or the title theory of mortgages (damages measured by amount of rents collected and not turned over). UARA provides that the assignor that fails to turn over collected rents following a proper demand by the assignee is liable to the assignee for all sums collected by the assignor. UARA § 14(b), (d). Any damages recovered by the assignee in an action under § 14, however, constitute security for the mortgage debt and must therefore be applied to the mortgage debt. UARA § 12.

- *Most tenants that receive notification to make rent payments to the assignee cannot thereafter discharge their rental obligation by paying the assignor.* Under the common law of contracts, the obligor can discharge its obligation by payment to the obligee until the obligor receives notification that the obligee has assigned the right to payment and the assignee directs the obligor to make payment to the assignee. UARA primarily tracks existing common law, providing that a tenant that receives notification to pay the assignee can only discharge its obligation by paying the assignee. UARA 9(c)(1)-(2). UARA does provide an exception for a tenant that occupies the premises as its primary residence, permitting such a tenant to satisfy its rental obligation by payment to either the assignee or the assignor. UARA § 9(c)(2).

- *An assignee that collects rents from the tenants or the assignor can apply the collected sums to the mortgage debt and need not apply the rents to the payment of expenses of maintaining the mortgaged real property (unless otherwise agreed by the mortgagee).* Tenants under commercial leases often pay sums called "rent" or "additional rent" based upon the tenant's proportionate share of real property taxes, insurance, and maintenance. An assignment of rents typically assigns the assignor's right to collect these payments to the assignee as security for the mortgage debt. Under prevailing law, an assignee that collects such rents can apply them to the debt, without obligation to use those sums for the payment of property-related expenses (unless the assignee has so agreed). UARA follows this prevailing view. UARA § 13(a). UARA preserves any claims or defenses that a tenant may have by virtue of the landlord's nonperformance of the lease, and also permits a tenant to seek appointment of a receiver if the assignee's nonpayment of property-related expenses causes or threatens harm to the tenant's interest in the mortgaged real property. UARA § 13(b), (c).

- *UARA establishes priority rules that govern disputes between interests created by real property law (a security interest in the cash proceeds of rents) and interests in the same property created under Article 9.* A perfected security interest in rents extends to the identifiable proceeds of those rents – typically, cash collections. Because cash monies – and the deposit accounts in which cash is typically maintained – are personal property in which a competing security interest can be created under Article 9, UARA provides coordinating priority rules to govern such priority disputes.

